SINGLE AUDIT REPORT

Mercyhurst College *E.I.N. 1-25-096-5430A1*
Years ended June 30, 2004 and 2003 with Report of Independent Auditors

Mercyhurst College

Single Audit Report

Years ended June 30, 2004 and 2003

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Report of Independent Auditors on the Financial Statements and Schedule of Expenditures of Federal Awards

Board of Trustees
Mercyhurst College

We have audited the accompanying statements of financial position of Mercyhurst College as of June 30, 2004 and 2003, and the related statements of activities and cash flows for the years then ended. These financial statements are the responsibility of the management of Mercyhurst College. 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 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. We were not engaged to perform an audit of Mercyhurst College's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of Mercyhurst College's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and 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, 2004 and 2003, 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.

In accordance with *Government Auditing Standards*, we have also issued our report dated September 10, 2004 on our consideration of the Mercyhurst College's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, 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 read in conjunction with this report in considering 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 is presented for purposes of additional analysis as required by U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit 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.

Ernst & Young LLP

September 10, 2004

Mercyhurst College

Statements of Financial Position

	June 30 2004	June 30 2003
Assets		
Cash and cash equivalents	**$ 7,962,995**	$ 7,816,262
Accounts receivable, net of allowance of $440,204 in 2004 and $529,471 in 2003	**1,655,290**	1,291,138
Contributions receivable, net of allowance of $137,840 in 2004 and 2003	**2,799,873**	3,467,545
Loans receivable, net of allowance of $139,270 in 2004 and 2003	**2,347,260**	2,228,158
Inventories	**300,648**	278,748
Prepaid expenses and other assets	**643,682**	394,299
Bond discount and issuance costs, net	**614,511**	575,534
Deposits with trustees	**6,891,772**	2,188,551
Long-term investments	**11,296,859**	7,962,178
Land, buildings and equipment, net	**57,723,758**	54,376,422
Total assets	**$ 92,236,648**	$ 80,578,835
Liabilities		
Accounts payable	**$ 2,406,048**	$ 1,331,171
Accrued expenses and other liabilities	**2,281,085**	1,979,676
Accrued interest	**436,450**	439,978
Student deposits	**1,038,141**	1,099,346
Deferred revenues	**602,676**	872,826
Notes payable	**1,376,748**	3,080,007
Bonds payable	**34,470,000**	29,970,000
Federal loan programs	**2,245,704**	2,196,800
Total liabilities	**44,856,852**	40,969,804
Net assets		
Unrestricted	**32,617,147**	28,316,699
Temporarily restricted	**6,306,496**	4,238,524
Permanently restricted	**8,456,153**	7,053,808
Total net assets	**47,379,796**	39,609,031
Total liabilities and net assets	**$ 92,236,648**	$ 80,578,835

See notes to financial statements.

Mercyhurst College

Statement of Activities

Year ended June 30, 2004

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Revenues, gains, and other support				
Tuition and fees	$ 53,223,848	$ -	$ -	$ 53,223,848
Less college funded financial aid	17,755,345	-	-	17,755,345
Net tuition and fees	35,468,503	-	-	35,468,503
Government grants	1,505,703	6,355,463	-	7,861,166
Private gifts and contracts	210,747	1,323,764	1,352,344	2,886,855
Investment income	225,259	174,302	-	399,561
Other revenues	660,487	358,477	-	1,018,964
Auxiliary enterprises	13,467,310	-	-	13,467,310
In-kind contributions	-	49,900	-	49,900
Realized and unrealized gains	310,151	814,334	-	1,124,485
Net assets released from restrictions	6,780,137	(6,780,137)	-	-
Total revenues	58,628,297	2,296,103	1,352,344	62,276,744
Expenses and other deductions				
Instruction	16,824,872	-	-	16,824,872
Public service	220,552	-	-	220,552
Academic support	1,492,679	-	-	1,492,679
Student services	7,750,716	-	-	7,750,716
Institutional support	6,847,964	-	-	6,847,964
Operation and maintenance of plant	4,815,097	-	-	4,815,097
Scholarships and fellowships	4,490,179	-	-	4,490,179
Auxiliary enterprises	7,846,931	-	-	7,846,931
Depreciation	2,652,394	-	-	2,652,394
Interest on indebtedness	1,607,519	-	-	1,607,519
Total expenses and other deductions	54,548,903	-	-	54,548,903
Excess of revenues over expenses and other deductions	4,079,394	2,296,103	1,352,344	7,727,841
Change in fair value of derivative	42,924	-	-	42,924
Transfer of net assets	178,130	(228,131)	50,001	-
Change in net assets	4,300,448	2,067,972	1,402,345	7,770,765
Net assets at beginning of year	28,316,699	4,238,524	7,053,808	39,609,031
Net assets at end of year	$ 32,617,147	$ 6,306,496	$ 8,456,153	$ 47,379,796

See notes to financial statements.

Mercyhurst College

Statement of Activities

Year ended June 30, 2003

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Revenues, gains, and other support				
Tuition and fees	$ 46,814,255	$ -	$ -	$46,814,255
Less college funded financial aid	14,935,678	-	-	14,935,678
Net tuition and fees	31,878,577	-	-	31,878,577
Government grants	1,411,493	5,931,919	-	7,343,412
Private gifts and contracts	217,158	1,148,552	1,264,011	2,629,721
Investment income	179,747	222,960	-	402,707
Other revenues	526,650	412,347	-	938,997
Auxiliary enterprises	12,415,301	1,004	-	12,416,305
In-kind contributions	-	57,305	-	57,305
Realized and unrealized investment losses	(7,109)	(21,781)	-	(28,890)
Net assets released from restrictions	9,858,279	(9,858,279)	-	-
Total revenues	56,480,096	(2,105,973)	1,264,011	55,638,134
Expenses and other deductions				
Instruction	15,834,625	-	-	15,834,625
Public service	198,999	-	-	198,999
Academic support	1,237,919	-	-	1,237,919
Student services	6,961,312	-	-	6,961,312
Institutional support	6,665,316	-	-	6,665,316
Operation and maintenance of physical plant	4,621,221	-	-	4,621,221
Scholarships and fellowships	3,965,186	-	-	3,965,186
Auxiliary enterprises	7,416,909	-	-	7,416,909
Depreciation	2,467,969	-	-	2,467,969
Interest on indebtedness	1,628,188	-	-	1,628,188
Total expenses and other deductions	50,997,644	-	-	50,997,644
Excess of revenues over expenses and other deductions	5,482,452	(2,105,973)	1,264,011	4,640,490
Change in fair value of derivative	23,386	-	-	23,386
Change in net assets	5,505,838	(2,105,973)	1,264,011	4,663,876
Net assets at beginning of year	22,810,861	6,344,497	5,789,797	34,945,155
Net assets at end of year	$ 28,316,699	$ 4,238,524	$ 7,053,808	$39,609,031

See notes to financial statements.

Mercyhurst College

Statements of Cash Flows

	Years ended June 30	
	2004	**2003**
Cash flows from operating activities		
Change in net assets	**$ 7,770,765**	$ 4,663,876
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation and amortization	**2,722,024**	2,534,569
Net realized and unrealized investment (losses) gains	**(1,124,485)**	28,890
Changes in operating assets and liabilities providing cash:		
Accounts receivable	**(364,152)**	147,679
Contributions receivable	**667,672**	579,462
Inventories	**(21,900)**	46,612
Prepaid expenses and other assets	**(249,383)**	(106,998)
Accounts payable	**1,074,877**	148,461
Accrued expenses and other liabilities	**297,881**	279,470
Student deposits	**(61,205)**	182,407
Deferred revenues	**(270,150)**	72,037
Gifts for long-term investment	**(1,115,084)**	(123,819)
Net cash provided by operating activities	**9,326,860**	8,452,646
Cash flows from investing activities		
Purchases of land, buildings, and equipment	**(6,108,337)**	(6,865,312)
Purchases of long-term investments	**(14,217,629)**	(7,950,153)
Proceeds from sales and maturities of long-term investments	**12,007,433**	7,200,522
Loan disbursements	**(546,379)**	(533,533)
Loan receipts	**427,277**	462,430
Change in deposits with trustees	**(4,703,221)**	293,505
Gifts for long-term investment	**1,115,084**	123,819
Net cash used in investing activities	**(12,025,772)**	(7,268,722)
Cash flows from financing activities		
Payments under line of credit agreements, net	**(961,244)**	-
Principal payments on bonds	**(975,000)**	(935,000)
Principal borrowings on bonds	**5,475,000**	-
Principal payments on notes payable	**(742,015)**	(727,769)
Principal borrowings on notes payable	**-**	1,997,480
Change in federal loan program grants, net	**48,904**	75,790
Net cash provided by financing activities	**2,845,645**	410,501
Net increase in cash and cash equivalents	**146,733**	1,594,425
Cash and cash equivalents at beginning of year	**7,816,262**	6,221,837
Cash and cash equivalents at end of year	**$ 7,962,995**	$ 7,816,262

See notes to financial statements.

Mercyhurst College

Notes to Financial Statements

June 30, 2004 and 2003

1. Summary of Significant Accounting Policies

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.

Basis of Presentation

The financial statements of the College have been prepared on the accrual basis of accounting.

Net assets and revenues, expenses, gains and losses are classified based on the existence or absence of donor-imposed restrictions. Accordingly, net assets of the College and changes therein are classified and reported as follows:

- *Unrestricted Net Assets* — Net assets that are not subject to donor-imposed stipulations.
- *Temporarily Restricted Net Assets* — Net assets subject to donor-imposed stipulations that may or will be met by either actions of the College and/or the passage of time.
- *Restricted Net Assets* — Net assets subject to donor-imposed stipulations that they be maintained permanently by the College. 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.

In 2004, College management completed a review of temporarily restricted funds and determined certain funds were not subject to restrictions and certain funds were subject to permanent restrictions, and as a result, reclassified $178,130 and $50,001 from temporarily restricted net assets to unrestricted net assets and permanently restricted net assets, respectively.

Cash Equivalents

The College considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents.

1. Summary of Significant Accounting Policies (continued)

Fair Value of Financial Instruments

The College's financial instruments include cash, cash equivalents, receivables, accounts payable, accrued expenses, and debt, the carrying amounts of which approximate fair value.

Student Accounts and Notes Receivable

The College's receivables are not collateralized, but credit losses have consistently been within management's expectations.

Contributions

Unconditional promises to give are recognized as revenues in the period the promises are received and are recorded as assets or decreases of liabilities or expenses depending on the form of the benefits received. Conditional promises to give are recognized when the conditions on which they depend are substantially met.

Donor-restricted support is reported as an increase in temporarily or permanently restricted net assets, depending on the nature of the restriction. When a restriction expires (that is when a 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.

Contributions other than cash are recorded at their estimated fair value.

Contributions to be received after one year are discounted at a discount rate which approximates current market rates. Amortization of the discount is recorded as additional contribution revenue.

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.

Inventories

Inventories are stated at the lower of first-in, first-out cost or market.

1. Summary of Significant Accounting Policies (continued)

Investments

Investments in debt and equity securities are stated at fair value based on quoted market prices. Other investments are carried at the lower of cost or market value.

Land, Buildings, and Equipment

Land, buildings, and equipment are stated at cost, and provisions for depreciation are computed on a straight-line basis over the estimated useful lives of the assets. Repairs, maintenance, and minor replacements of existing facilities are charged to expense as incurred.

Collections

The College follows a policy of not recording or capitalizing its collections of works of art, historical treasures, and similar assets. The estimated value of the collections is not material to the financial statements.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States 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 and expenses during the reporting period. Actual results could differ from those estimates.

Federal Loan Programs

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.

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.

1. Summary of Significant Accounting Policies (continued)

Income Taxes

Mercyhurst College is exempt from Federal income taxes under Section 501(a) of the Internal Revenue Code (the Code) as an organization described under Section 501(c) of the Code.

Reclassifications

Certain amounts in the 2003 financial statements have been reclassified to conform with the 2004 presentation.

2. Contributions Receivable and Conditional Promises Received

Contributions receivable, net, are summarized as follows:

	June 30	
	2004	**2003**
Unconditional promises expected to be collected in:		
Less than one year	**$ 739,502**	$ 1,341,887
One to five years	**878,646**	1,084,071
Over five years	**1,319,565**	1,179,427
	2,937,713	3,605,385
Less allowance for uncollectible contributions	**137,840**	137,840
	$ 2,799,873	$ 3,467,545

As a result of the capital campaign, at June 30, 2004, the College has been named in will commitments totaling $ 2,150,000, which are not reflected in the financial statements, as they are considered conditional promises to give.

3. Land, Buildings, and Equipment

Land, buildings, and equipment, which are recorded at cost, are summarized as follows:

	June 30	
	2004	**2003**
Land	**$ 1,021,249**	$ 1,021,249
Land improvements	**6,419,496**	5,690,580
Buildings	**58,838,369**	55,940,948
Furnishings and equipment	**14,959,613**	14,287,093
Library books	**3,483,504**	3,240,397
	84,722,231	80,180,267
Construction-in-progress	**1,574,702**	116,936
	86,296,933	80,297,203
Accumulated depreciation	**(28,573,175)**	(25,920,781)
Land, buildings, and equipment, net	**$ 57,723,758**	$ 54,376,422

4. Fair Value of Financial Instruments

Quoted market or appraised values of deposits with trustees and long-term investments of the funds indicated were as follows:

	June 30	
	2004	**2003**
Unrestricted funds	**$ 7,643,868**	$ 2,619,121
Temporarily restricted funds	**2,632,417**	1,354,613
Permanently restricted funds	**7,912,346**	6,176,995
	$ 18,188,631	$ 10,150,729

4. Fair Value of Financial Instruments (continued)

Investments, including deposits with trustees, are summarized as follows:

	June 30	
	2004	**2003**
Cash equivalents	**$ 814,350**	$ 462,011
U.S. government obligations	**2,079,826**	1,798,670
Collective fixed income funds	**2,342,577**	2,514,854
Collective equity funds	**5,278,935**	1,907,014
Guaranteed investment contract	**4,700,001**	-
Equity securities	**2,537,440**	3,032,678
Real estate	**424,002**	424,002
Other	**11,500**	11,500
	$ 18,188,631	$ 10,150,729

On November 1, 2001, the College entered into an interest rate swap to manage the risk associated with changes in interest rates over the life of the 2001 bonds (Note 7). The interest rate swap provided for the College to pay an amount equal to a specified fixed rate of interest times a notional principal amount and to receive in return an amount equal to a variable rate of interest times the same notional amount. The notional amounts were never exchanged. The swap agreement was for a notional amount equal to $5,500,000 of the College's 2001 bonds maturing on November 1, 2021 with an effective date of November 1, 2002.

4. Fair Value of Financial Instruments (continued)

The interest rate swap qualified as a hedge of the amount of future cash flows related to interest payments on variable rate debt. Therefore, the interest rate swap is included in accrued expenses and other liabilities on the statement of financial position at fair value at June 30, 2004 and 2003, and the related gain or loss change in fair value is recorded as a component of net assets. These deferred gains and losses are amortized into interest expense during the periods in which the related interest payments affect earnings, which began November 1, 2002. The swap converted the notional amount of variable rate debt to a fixed rate of 3.53%. On November 1, 2003 the swap agreement matured, and the College paid $48,662 in settlement.

Activity in net assets related to derivatives held by the College during the period from July 1, 2002 through June 30, 2004 is summarized below:

Accumulated loss on derivatives at June 30, 2002	$ (66,310)
Net decrease in fair value of derivatives	(49,032)
Net reclassification from net assets into earnings	72,418
	23,386
Accumulated loss on derivatives at June 30, 2003	**(42,924)**
Net reclassification from net assets into earnings	**42,924**
Accumulated loss on derivatives at June 30, 2004	**$ -**

5. Accrued Expenses and Other Liabilities

Accrued expenses and other liabilities consist of the following:

	June 30	
	2004	**2003**
Accrued payroll and deferred compensation	**$ 1,569,049**	$ 1,435,562
Accrued payroll taxes and withholdings	**186,106**	104,436
Accrued vacation	**350,820**	340,476
Fair value of derivative	**-**	42,924
Other accrued expenses	**175,110**	56,278
	$ 2,281,085	$ 1,979,676

6. Pension Plan

Retirement benefits are provided for College employees through the Teachers Insurance and Annuity Association/College Retirement Equities Fund (T.I.A.A./C.R.E.F.), a national organization, and the Variable Annuity Life Insurance Company (V.A.L.I.C.), used to fund pension benefits for educational institutions. Under the arrangement, the College and plan participants make monthly contributions to T.I.A.A./C.R.E.F. and V.A.L.I.C. to fund retirement benefits through an insured defined contribution plan. The plan covers substantially all eligible employees. The College's share of the cost of these benefits for the years ended June 30, 2004 and 2003 was $820,744 and $722,199, respectively.

7. Line-of-Credit and Long-Term Debt

Long-term debt consists of the following:

	June 30	
	2004	**2003**
Notes payable:		
Line of Credit	**$ 576,921**	$ 1,538,165
Note payable – GMACRAT	**778,977**	1,499,708
Other	**20,850**	42,134
Total notes payable	**1,376,748**	3,080,007
Bonds payable:		
College Revenue Refunding Bonds Series A and B of 1993, with interest rates ranging from 5.30% to 5.75%	**17,880,000**	18,625,000
College Revenue Refunding Bonds of 1997, with interest rates ranging from 5.25% to 5.85%	**2,515,000**	2,645,000
Pennsylvania Higher Education Facilities Authority Revenue Bonds Series 1999 E1, with interest at 2.0% at June 30, 2004 and until November 1, 2006 and at 4.0% thereafter	**3,100,000**	3,200,000
Pennsylvania Higher Education Facilities Authority Revenue Bonds Series 2001 I2, with interest at 1.13% at June 30, 2004 and until November 1, 2004 and at 4.0% thereafter	**5,500,000**	5,500,000
College Revenue Bonds of 2003, with interest at 3.25% at June 30, 2004 and until November 1, 2006 and at 4.00% thereafter	**5,475,000**	-
Total bonds payable	**34,470,000**	29,970,000
Total long-term debt	**$ 35,846,748**	$ 33,050,007

The College currently has two line-of-credit arrangements with two local banks that provide the College up to a total of $2,000,000 for physical plant improvement projects and working capital.

7. Line-of-Credit and Long-Term Debt (continued)

The first agreement is for capital expenditures and expires on December 29, 2005. This note replaced the $2,000,000 line-of-credit, which expired on June 30, 2004. 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 is for capital expenditures and working capital and expires March 1, 2006. The note accrues 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% is also assessed on any unused portion of the line-of-credit. Borrowings on the second line are unsecured and are a general obligation of the College. At June 30, 2004 and 2003, the balances outstanding under the lines-of-credit were $576,921 and $1,538,165 respectively.

On March 1, 2000, the College issued a $1,950,000 installment note to the Glenwood Manor Apartment Charitable Remainder Annuity Trust (GMACRAT) in exchange for four apartment buildings used for student housing. The installment note required 32 monthly installments of $67,692 including interest at a rate of 7.8% per annum, which commenced on March 31, 2000 and ended October 31, 2002. The note was secured by the four apartment buildings. This note was fully paid in the fiscal year ended June 30, 2003.

On November 1, 2002, the College issued another $1,950,000 installment note to the GMACRAT in exchange for four additional apartment buildings currently used for student housing. The installment note requires 32 monthly installments of $67,692 including interest at a rate of 7.8% per annum, which commenced on November 30, 2002 and will end on June 30, 2005. The note is secured by the four apartment buildings. Cash to make approximately 12 monthly installments to the GMACRAT was obtained in the 2003 Bond issue (Note 13), and is held on deposit with a trustee. The balance of the principal and interest payments on the note will be paid from the College's operating cash. The College is the charitable organization, as defined by the charitable remainder annuity trust agreement. Accordingly, upon termination of the GMACRAT, which is July 31, 2005, the trustees shall distribute all of the then principal and income of the GMACRAT to the College.

7. Line-of-Credit and Long-Term Debt (continued)

In October 1993, the College issued $17,595,000 College Revenue Refunding Bonds, Series A of 1993, and $6,120,000 College Revenue Refunding Bonds, Series B of 1993 (collectively, the 1993 Bonds) through the City of Erie Higher Education Authority (the Authority). 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.

On July 3, 1997, the College entered into a $3,920,000 bond issuance with 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 entered into a $3,500,000 bond issue with 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 entered into a $5,500,000 bond issue with 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 entered into a $5,475,000 bond issue with the City of Erie Higher Education Building 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.

The College is subject to certain financial and reporting covenants under the 1993, 1997, 1999, 2001, and 2003 Bond issues.

7. Line-of-Credit and Long-Term Debt (continued)

As part of the 1993 and 1997 Bond issues, the Authority entered into a Sublease and Security Agreement and a 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 1993 and 1997 Bonds.

The 1993 and 1997 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 $3,190,417. The letter of credit expires November 15, 2005 and is renewable thereafter. On September 4, 2003, the expiration date of the letter of credit was extended to November 15, 2006.

The 2001 Bonds are secured by a letter of credit with a bank in the amount of $5,660,417. The letter of credit expires November 15, 2005 and is renewable thereafter.

The 2003 Bonds are secured by a letter of credit with a bank in the amount of $5,578,797. The letter of credit expires November 15, 2006 and is renewable thereafter.

The mandatory redemption and sinking fund requirements to redeem or otherwise retire principal amounts of the 1993, 1997, 1999, 2001 and 2003 Bonds are as follows:

- *1993 Series A Bonds* — Ranging from $640,000 in 2005 to $1,165,000 in 2017, $690,000 in 2018, $735,000 in 2019, and $125,000 in 2020 at maturity.

- *1993 Series B Bonds* — Ranging from $150,000 in 2005 to $410,000 in 2023.

- *1997 Bonds* — Ranging from $135,000 in 2005 to $265,000 in 2007.

- *1999 Bonds* — Ranging from $100,000 in 2005 to $300,000 in 2020.

- *2001 Bonds* — Ranging from $200,000 in 2006 to $500,000 in 2022.

- *2003 Bonds* — Ranging from $150,000 in 2005 to $400,000 in 2024.

7. Line-of-Credit and Long-Term Debt (continued)

Principal payments due on the long-term debt during the next five fiscal years ending June 30 are as follows:

2005	$ 1,970,540
2006	1,424,299
2007	1,495,000
2008	1,675,000
2009	1,735,000

Interest paid during fiscal 2004 and 2003 amounted to $1,569,146 and $1,658,423, respectively. Interest capitalized during fiscal 2004 and 2003 amounted to $2,492 and $38,851, respectively.

8. Commitments

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 2004 and 2003 was $1,656,384 and $1,324,341, respectively.

Minimum future rentals under noncancelable operating leases during the next five fiscal years ending June 30 and thereafter are as follows:

2005	$ 1,351,414
2006	1,129,825
2007	803,858
2008	596,705
2009	544,044
Thereafter	2,912,769
	$ 7,338,615

9. Contingencies

The College is involved in certain matters of litigation arising in the ordinary course of business. While the ultimate outcome of this litigation cannot be reasonably predicted, it is management's opinion that an unfavorable outcome, if any, will not materially affect the financial position and results of operations of the College.

10. Expense Summary

Expenses classified by natural classification are summarized as follows:

	Years ended June 30	
	2004	**2003**
Salaries and wages	**$ 20,073,829**	$ 18,487,040
Fringe benefits	**6,109,422**	5,004,590
Contract services	**2,076,827**	2,098,705
Supplies	**1,206,282**	1,161,435
Travel	**1,383,625**	1,248,625
Repairs and maintenance	**1,389,831**	1,398,797
Utilities	**1,759,000**	1,669,915
Scholarships, externally funded	**4,490,179**	3,965,186
Cost of sales for auxiliary enterprises	**4,178,102**	3,729,098
Bad debts	**227,598**	388,021
Rents and leases	**1,671,756**	1,337,370
Non-capital equipment	**846,581**	1,216,262
Interest on indebtedness	**1,607,519**	1,628,188
Insurance	**455,105**	434,108
Depreciation and amortization	**2,722,024**	2,534,569
Other	**4,351,223**	4,695,735
	$ 54,548,903	$ 50,997,644

11. Restrictions and Limitations on Net Asset Balances

Temporarily restricted net assets consist of capital gains and gifts, which are available for the following purposes or in future periods:

	June 30	
	2004	**2003**
Student services	**$ 55,029**	$ 59,025
Institutional support	**873,770**	660,436
Loan funds	**813,462**	767,930
Instruction	**2,196,140**	1,993,220
Academic support	**9,883**	10,319
Scholarships	**657,416**	41,494
Plant operations and additions	**1,677,187**	689,422
Public service	**23,609**	16,678
	$ 6,306,496	$ 4,238,524

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

	June 30	
	2004	**2003**
Institutional support	**$ 1,017,408**	$ 1,017,413
Scholarships	**7,180,962**	5,881,122
Instructional	**195,574**	93,064
Public service	**62,209**	62,209
	$ 8,456,153	$ 7,053,808

12. Net Assets Released from Restriction

The following net assets were released from donor restrictions during the year by incurring expenditures satisfying the restricted purposes or by occurrence of other events specified by the donors.

	Years ended June 30	
	2004	**2003**
Purpose of restrictions accomplished:		
Instructional activities	**$ 2,473,825**	$ 2,806,506
Public service activities	**10,518**	1,777
Academic support services	**-**	182
Student service activities	**253,228**	183,526
Student service grants	**138,851**	196,509
Institutional support activities	**177,988**	580,985
Operation and maintenance of plant	**24,108**	87,802
Governmental scholarship grants	**3,062,632**	3,518,836
Student aid	**454,911**	446,350
	6,596,061	7,822,473
Plant fund expenditures	**184,076**	2,035,806
	$ 6,780,137	$ 9,858,279

13. Subsequent Event

On September 2, 2004, the College obtained approval from the City of Erie Higher Education Building Authority (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. The College also obtained approval from the Authority to refinance the 1993 Bonds. The College intends to issue $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) to refinance the 1993 Bonds with interest rates ranging from 2.20% to 5.00%. The maturity dates of the 2004 Bonds will be the same as the 1993 Bonds. Both issues were approved by City of Erie City Council at its meeting on September 8, 2004.

Mercyhurst College

Schedule of Expenditures of Federal Awards

Year ended June 30, 2004

Federal Grantor/Pass-Through Grantor/ or Cluster Title	Federal CFDA Number	Pass-Through Entity Identifying Number	Federal Expenditures
U.S. Department of Education			
Student Financial Assistance:			
Federal Work Study Program	84.033		$ 383,565
Federal Pell Grant Program	84.063		2,335,167
Federal Supplemental Education Opportunity Grant	84.007		532,400
Federal Perkins Loan Program *(Note 1)*	84.038		51,907
Federal Family Education Loan Program *(Note 2)*	84.032		-
Intelligence Research and Analysis	84.116Z		34,774
Pass-through from Pennsylvania Department of Education			
Vocational Education Program	84.048	23-600-3115	111,506
PT3 Prep Tomorrow's Teachers for Technology	84.342A	23-600-3115	365,128
Total U.S. Department of Education			3,814,447
U.S. Department of Labor			
Pass-through from Pennsylvania Department of Labor			
Trade Adjustment Act Program	17.245	23-600-3107	499,692
Pre Teaching Academy TANF Challenge Grant	17.000	25-129-3830	5,519
Total U.S. Department of Labor			505,211
U.S. Department of Justice			
RIAP/Intelligence Training	21.060		11,194
RIAP/FMSC Case Studies	16.000		13,741
Pass-through from Pennsylvania Commission on Crime and Delinquency			
PCCD – Institute for Child and Family Policy (County of Erie)	16.523	25-600-1027	12,959
Drug Control and Systems Improvement (County of Erie)	16.579	25-600-1027	18,245
RIAP/University of Arkansas Terrorism	16.560	71-600-3252	25,819
Total U.S. Department of Justice			81,958

Mercyhurst College

Schedule of Expenditures of Federal Awards (continued)

Federal Grantor/Pass-Through Grantor/ or Cluster Title	Federal CFDA Number	Pass-Through Entity Identifying Number	Federal Expenditures
U.S. Department of Health and Human Services			
NE Health Care Facilities and Other Construction	93.887		23,562
Child Care Development Block Grant	93.575		20,793
Start Smart Foundation	93.959		23,952
Total U.S. Department of Health and Human Services			68,307
U.S. Department of Defense			
Intergovernmental Personnel Act Mobility Program	27.011		69,978
DOD Excavations at Rockshelters	12.421		326,131
DOD National Security Administration	12.0663		37,299
Total U.S. Department of Defense			433,408
Total Expenditures of Federal Awards			$ 4,903,331

See accompanying notes.

Mercyhurst College

Schedule of Expenditures of Federal Awards (continued)

1. Federal Perkins Loan Program

	CFDA Number	Outstanding Balance at June 30, 2004
Federal Perkins Loan Program	84.038	$ 2,476,699

Total loan expenditures and disbursements of the Department of Education student financial assistance program for the fiscal year are identified below:

	CFDA Number	Loans Advanced to Students
Federal Perkins Loan Program	84.038	$ 535,181

The Schedule of Expenditures of Federal Awards for the Federal Perkins Loan Program represents the Federal Capital Contribution for the year ended June 30, 2004, which includes the administrative costs of the Federal Perkins Loan Program.

2. Federal Family Education Loan Program

During the fiscal year ending June 30, 2004, the University processed the following amount of new loans under the Federal Family Education Loan Program (which includes Stafford Loans and Parents' Loans for Undergraduate Students):

	CFDA Number	Amount Processed
Federal Family Education Loan Program	84.032	$ 19,773,160

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Report of Independent Auditors 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

We have audited the financial statements of Mercyhurst College as of and for the year ended June 30, 2004, and have issued our report thereon dated September 10, 2004. We conducted our audit in accordance with auditing standards generally accepted in the United States 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 our audit, we considered Mercyhurst 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 Mercyhurst 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 do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of the Board of Trustees, management, 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.

Ernst & Young LLP

September 10, 2004

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Report of Independent Auditors on Compliance and on Internal Control Over Compliance with OMB Circular A-133

Board of Trustees
Mercyhurst College

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, 2004. Mercyhurst 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 Mercyhurst College's management. Our responsibility is to express an opinion on Mercyhurst College's compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and 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 Mercyhurst 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 Mercyhurst 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, 2004.

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 Mercyhurst 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 to 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 Board of Trustees, management, 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.

Ernst & Young LLP

September 10, 2004

Mercyhurst College

Schedule of Findings and Questioned Costs

Year ended June 30, 2004

Part I—Summary of Auditor's Results

Financial Statement Section

Type of auditor's report issued:	Unqualified Opinion

	Yes	No
Internal control over financial reporting:		
• Material weakness(es) identified?		X
• Reportable condition(s) identified that are not considered to be material weaknesses?		X
• Noncompliance material to financial statements noted?		X

Federal Awards Section

	Yes	No
Internal control over major programs:		
• Material weakness(es) identified?		X
• Reportable condition(s) identified that are not considered to be material weaknesses?		None Reported

Type of auditor's report issued on compliance for major programs:	Unqualified Opinion

	Yes	No
Any audit findings disclosed that are required to be reported in accordance with Circular A-133 (section .510(a))?		X

Mercyhurst College

Schedule of Findings and Questioned Costs (continued)

Part I—Summary of Auditor's Results (continued)

Federal Awards Section (continued)

Identification of major programs:

CFDA Number(s)	Name of Federal Program or Cluster
84.033, 84.063, 84.007, 84.038	Student Financial Aid - Cluster
12.421	DOD Excavations at Rockshelters

Dollar threshold used to determine Type A programs: $300,000

	Yes	No
Auditee qualified as low-risk auditee?	X	

Part II—Schedule of Financial Statement Findings

This section identifies the reportable conditions, material weaknesses, fraud, illegal acts, violations of provisions of contracts and grant agreements, and abuse related to the financial statements for which *Government Auditing Standards* require reporting in a Circular A-133 audit.

None.

Part III—Schedule of Federal Award Findings and Questioned Costs

This section identifies the audit findings required to be reported by Circular A-133 section .510 (for example, reportable conditions, material weaknesses, and material instances of noncompliance, including questioned costs), as well as any abuse findings involving federal awards that are material to a major program. Where practical, findings should be organized by federal agency or pass-through entity.

None.