

Mercyhurst University

Accountants' Report and Consolidated Financial Statements

May 31, 2012



Mercyhurst University
May 31, 2012

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Independent Accountants' Report on Consolidated Financial Statements and Supplementary Information

Board of Trustees
Mercyhurst University
Erie, Pennsylvania

We have audited the accompanying consolidated statement of financial position of Mercyhurst University as of May 31, 2012 and the related consolidated statement of activities and cash flows for the year then ended. These consolidated financial statements are the responsibility of the University's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

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. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated 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 audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Mercyhurst University as of May 31, 2012 and the changes in its net assets and its cash flows for the year 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 October 2, 2012, on our consideration of the University'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 audit was conducted for the purpose of forming an opinion on the consolidated financial statements 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*, as listed in the table of contents, is presented for purposes of additional analysis and is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

BKD, LLP

October 2, 2012

Mercyhurst University
Consolidated Statement of Financial Position
May 31, 2012

Assets

Cash and cash equivalents	\$ 14,956,298
Accounts receivable, net of allowance of \$723,805	3,012,684
Contributions receivable, net	2,014,498
Beneficial interest in charitable remainder trust	575,978
Loans receivable, net of allowance of \$118,677	2,386,886
Inventories	505,163
Prepaid expenses and other assets	380,135
Bond discount and issuance costs, net	488,063
Deposits with trustees	3,061,646
Long-term investments	24,945,722
Land, buildings and equipment, net	<u>96,641,764</u>
Total assets	<u>\$ 148,968,837</u>

Liabilities and Net Assets

Liabilities

Accounts payable	\$ 2,792,994
Accrued expenses and other liabilities	4,128,901
Accrued interest	408,511
Student deposits	1,552,468
Deferred revenue	311,021
Notes payable and capital leases	1,330,435
Bonds and bank note payable	41,215,000
Federal government advances for student loans	2,269,786
Trusts payable	<u>44,370</u>
Total liabilities	54,053,486

Net Assets

Unrestricted	72,935,718
Temporarily restricted	5,134,156
Permanently restricted	<u>16,845,477</u>
Total net assets	<u>94,915,351</u>
Total liabilities and net assets	<u>\$ 148,968,837</u>

See Notes to Consolidated Financial Statements

Mercyhurst University
Consolidated Statement of Activities
Year Ended May 31, 2012

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
Revenues, Gains and Other Support				
Tuition and fees	\$ 92,406,092	\$ -	\$ -	\$ 92,406,092
Less: university funded financial aid and scholarships	43,059,125	-	-	43,059,125
Net tuition and fees	49,346,967	-	-	49,346,967
Government grants and other contracts	10,675,728	-	-	10,675,728
Private gifts	906,752	804,288	259,499	1,970,539
Appropriation of endowment investment return	95,493	924,192	-	1,019,685
Other investment return	272,321	1,397	-	273,718
Other revenues	1,694,323	-	-	1,694,323
Auxiliary enterprises	21,811,526	-	-	21,811,526
Change in value of split interest agreements	-	197,731	-	197,731
Reclassification of net assets	-	(739,712)	739,712	-
Net assets released from restrictions	1,345,219	(1,345,219)	-	-
Total revenues, gains and other support	86,148,329	(157,323)	999,211	86,990,217
Expenses and Other Deductions				
Instruction	35,674,684	-	-	35,674,684
Public service	266,889	-	-	266,889
Academic support	3,036,250	-	-	3,036,250
Student services	14,407,531	-	-	14,407,531
Institutional support	11,717,026	-	-	11,717,026
Auxiliary enterprises	14,526,055	-	-	14,526,055
Interest	1,802,580	-	-	1,802,580
Total expenses and other deductions	81,431,015	-	-	81,431,015
Change in net assets from operating activities	4,717,314	(157,323)	999,211	5,559,202
Non-Operating Activities				
Change in fair value of interest rate swap	143,464	-	-	143,464
Contributions for capital expenditures	250,471	532,909	-	783,380
Investment return on funds for plant assets	60,218	-	-	60,218
Net assets released from restrictions	31,402	(31,402)	-	-
Endowment investment return, in excess of appropriation	(1,769,554)	(941,883)	-	(2,711,437)
Change in net assets from non-operating activities	(1,283,999)	(440,376)	-	(1,724,375)
Change in Net Assets	3,433,315	(597,699)	999,211	3,834,827
Net Assets, Beginning of Year	69,502,403	5,731,855	15,846,266	91,080,524
Net Assets, End of Year	\$ 72,935,718	\$ 5,134,156	\$ 16,845,477	\$ 94,915,351

See Notes to Financial Statements

Mercyhurst University
Consolidated Statement of Cash Flows
Year Ended May 31, 2012

Operating Activities

Change in net assets	\$	3,834,827
Items not requiring (providing) operating cash flows		
Depreciation and amortization		4,476,493
Net realized and unrealized losses on investments		1,895,891
Change in value of split interest agreements		(197,731)
Contributions received restricted for long-term investment		(259,499)
Changes in		
Receivables		1,052,608
Inventories		(58,268)
Prepaid expenses and other assets		51,079
Accounts payable		483,449
Accrued expenses and other liabilities		250,810
Student deposits		(124,301)
Deferred revenue		78,683
Federal government advances for student loans		1,894
		11,485,935
Net cash provided by operating activities		11,485,935

Investing Activities

Purchase of land, buildings and equipment		(9,881,361)
Purchase of long-term investments		(6,989,011)
Proceeds from disposition of long-term investments		6,679,047
Change in deposits with trustees		89,055
		(10,102,270)
Net cash used in investing activities		(10,102,270)

Financing Activities

Principal payments on bonds		(2,280,000)
Principal payments on notes payable		(242,777)
Proceeds from issuance of bank note		9,600,000
Payments for retirement of bonds		(9,600,000)
Payments for bond issuance costs		(53,100)
Proceeds from contributions restricted for long-term investment		259,499
		(2,316,378)
Net cash used in financing activities		(2,316,378)

Decrease in Cash and Cash Equivalents (932,713)

Cash and Cash Equivalents, Beginning of Year 15,889,011

Cash and Cash Equivalents, End of Year \$ 14,956,298

Supplemental Cash Flows Information

Interest paid	\$	1,966,594
Income taxes paid		15,515

See Notes to Financial Statements

Mercyhurst University
Notes to Consolidated Financial Statements
May 31, 2012

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

Nature of Operations

Mercyhurst University ("University") 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 University's revenues are derived from tuition and fees charged to students. In fiscal 2011, the University changed its year end from June 30 to May 31. In fiscal 2012, the institution attained University status.

Principles of Consolidation

The consolidated financial statements include the accounts of the University and Mercyhurst College, Ireland ("MCI"). MCI was incorporated under the Companies Acts 1963 to 2009 of Ireland as a company limited by guarantee on March 12, 2012. MCI is located at Dungarvan Enterprise Centre, Dungarvan, County Waterford, Ireland. The purpose of MCI is threefold: 1. to offer term-length undergraduate courses to U.S. students through its Centre for International Education; 2. to provide graduate training and certificate programs in analytics and competitive intelligence to students from the European Union through its Center for Intelligence Research Analysis and Training ("CIRAT") Europe; and 3. to deliver courses, in cooperation with Irish Universities, through its Centre for International Academic Partnerships. All significant intercompany accounts and transactions have been eliminated in consolidation.

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.

Operating and Non-Operating Activities

For the purpose of the consolidated statement of activities, the University considers its changes in unrestricted net assets to be operational changes, except for the University's interest rate swap and realized and unrealized gains and losses on endowment investments in excess of the University's spending rate. In addition, contributions and investment return received or earned of a capital nature, that is, to be used for facilities and equipment or to be invested by the University to generate a return that will support operations, are included in non-operating activities and classified as unrestricted, temporarily restricted, or permanently restricted net assets. Gains and losses related to the sale or disposal of facilities and equipment are also recorded in this category.

Mercyhurst University
Notes to Consolidated Financial Statements
May 31, 2012

Cash Equivalents

With the exception of certain investments held in the endowment fund, the University considers all liquid investments with original maturities of three months or less to be cash equivalents. At May 31, 2012, cash equivalents consisted primarily of money market accounts with brokers and certificates of deposit.

Effective July 21, 2010, the FDIC's insurance limits were permanently increased to \$250,000. At May 31, 2012, the University's cash accounts exceeded federally insured limits by approximately \$13,502,000.

Pursuant to legislation enacted in 2010, the FDIC will fully insure all noninterest-bearing transaction accounts beginning December 31, 2010 through December 31, 2012, at all FDIC-insured institutions.

Fair Value of Financial Instruments

The University'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. 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 University 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 five to seven days prior to the first day of the winter and spring terms. The University also offers payment plans which allow students to make three payments throughout the term, or nine or twelve 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 University provides an allowance for doubtful accounts, which is based upon a review of the outstanding student receivables along with current and historical collection information.

Mercyhurst University
Notes to Consolidated Financial Statements
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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 is recorded at cost and not depreciated. Land improvements, 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.

The University capitalizes interest costs as a component of construction in progress, based on interest costs of borrowing specifically for the project, net of interest earned on investments acquired with the proceeds of the borrowing. Total interest capitalized in 2012 was:

Total interest expense incurred on borrowings for project	\$ 53,453
Interest income from investment of proceeds of borrowings for project	_____
Net interest cost capitalized	<u>\$ 53,453</u>

Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are those whose use by the University 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 University in perpetuity. Generally, the donors of these assets permit the University 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.

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Notes to Consolidated Financial Statements
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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 consolidated financial statements. The University'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 University's bookstores that are stated at the lower of cost or market using the first-in, first-out (FIFO) method.

Federal Government Advances for Student Loans

The University 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 University 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.

Mercyhurst University
Notes to Consolidated Financial Statements
May 31, 2012

Income Taxes

The University 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 University is subject to federal income tax on any unrelated business income.

The University files tax returns in the U.S. Federal jurisdiction. With a few exceptions, the University is no longer subject to U.S. Federal examinations by tax authorities for years before 2008.

Self Insurance

The University has elected to self-insure certain costs related to employee health and accident benefit programs. Costs resulting from noninsured losses are charged to income when incurred. The University has purchased insurance that limits its exposure for individual claims and that limits its aggregate exposure to approximately \$3,500,000.

Reclassifications

During 2012 a charitable remainder trust donated to the University was dissolved by the donor and the proceeds were recorded in a temporarily restricted account. Pursuant to a change in the donor's restriction to establish a permanent endowed chair, \$605,683 of the proceeds received were reclassified to the permanently restricted fund.

In addition, an endowed scholarship agreement requires that any unspent earnings remaining in the temporarily restricted account be transferred to the permanently restricted portion of the scholarship account. In fiscal year 2012, \$134,029 was transferred to the permanently restricted fund.

Those net assets were reclassified in the 2012 consolidated financial statements to appropriately recognize the restricted nature of the net asset balances:

Temporarily restricted	(739,712)
Permanently restricted	739,712

Mercyhurst University
Notes to Consolidated Financial Statements
May 31, 2012

Note 2: Contributions Receivable and Conditional Gifts

Contributions receivable consisted of the following:

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
Due within one year	\$ 304,038	\$ 68,140	\$ 109,634	\$ 481,812
Due in one to five years	509,207	277,385	1,143,806	1,930,398
Due in more than five years	<u>-</u>	<u>25,667</u>	<u>7,750</u>	<u>33,417</u>
	813,245	371,192	1,261,190	2,445,627
Less				
Allowance for uncollectible contributions	(19,043)	(8,207)	(27,750)	(55,000)
Unamortized discount	<u>(101,811)</u>	<u>(61,291)</u>	<u>(213,027)</u>	<u>(376,129)</u>
	<u>\$ 692,391</u>	<u>\$ 301,694</u>	<u>\$ 1,020,413</u>	<u>\$ 2,014,498</u>

The discount rate used was 6%.

The University has been named in will commitments totaling \$2,780,000 at May 31, 2012 which are not reflected in the consolidated financial statements, as they are considered conditional promises to give.

Note 3: Beneficial Interest in Charitable Remainder Trust

The University is the beneficiary under a charitable remainder trust for which it is not the trustee. The University'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 May 31, 2012, the University's beneficial interest in the remainder trust administered by an outside party is \$575,978.

Mercyhurst University
Notes to Consolidated Financial Statements
May 31, 2012

Note 4: Long-Term Investments and Investment Return

Investments, including deposits with trustees, at May 31, 2012 consisted of the following:

Money market mutual funds	\$ 1,638,250
Equity securities	1,392,723
U.S. Treasury securities	1,476,341
Equity mutual funds	
Index funds	3,963,191
Growth funds	1,653,412
Value funds	3,330,460
Blended funds	1,551,679
International funds	2,731,727
Fixed income mutual funds	7,923,265
Hedge fund-of-funds	1,924,152
Other	<u>422,168</u>
	<u>\$ 28,007,368</u>

Total investment return is comprised of the following:

Interest and dividend income	\$ 538,075
Net realized and unrealized gains and losses	<u>(1,895,891)</u>
	<u>\$ (1,357,816)</u>

Mercyhurst University
Notes to Consolidated Financial Statements
May 31, 2012

Alternative Investments

The fair value of the Hedge fund-of-funds has been estimated using the net asset value per share of the investments. Alternative investments held at May 31, 2012 consist of the following:

	Fair Value	Unfunded Commitments	Redemption Frequency	Redemption Notice Period
PA Stable Value Fund (A)	\$ 909,307	\$ -	Semi - Annual	Redemption on June 30 and December 31 with 95 days written notice
Common Sense Fund (B)	\$ 1,014,845	\$ -	Quarterly	Redemption of up to 25% of account on the last day of each calendar quarter or all or any portion as of December 31 with 100 days written notice

- (A) This category includes an investment in a hedge fund that pursues multiple strategies to diversify risks and reduce volatility. The fund's composite portfolio includes investments in U.S. common stocks, global real estate projects, arbitrage investments, fixed income and other related strategies. There are no redemption restrictions for the investment.
- (B) This category includes an investment in a hedge fund that takes both long and short positions, primarily in U.S. common stocks. Management of the funds has the ability to shift investments among differing investment strategies. There are no redemption restrictions for the investment.

Mercyhurst University
Notes to Consolidated Financial Statements
May 31, 2012

Note 5: Endowment

The University's endowment consists of 179 individual funds established for a variety of purposes. The endowment includes both donor-restricted endowment funds and funds designated by the Board of Trustees to function as endowments (board-designated endowment funds). As required by accounting principles generally accepted in the United States of America (GAAP), net assets associated with endowment funds, including board-designated endowment funds, are classified and reported based on the existence or absence of donor-imposed restrictions. The minimum protected endowment of \$500,000 as required by the University's Articles of Incorporation is included in Board-designated endowment funds.

The composition of net assets by type of endowment fund at May 31, 2012 consisted of the following:

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Donor-restricted endowment funds	\$ (2,093,616)	\$ 1,859,605	\$ 16,845,477	\$ 16,611,466
Board-designated endowment funds	<u>8,404,143</u>	<u>-</u>	<u>-</u>	<u>8,404,143</u>
Total endowment funds	<u>\$ 6,310,527</u>	<u>\$ 1,859,605</u>	<u>\$ 16,845,477</u>	<u>\$ 25,015,609</u>

Changes in endowment net assets for the year ended May 31, 2012 was as follows:

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Endowment net assets, beginning of year	<u>\$ 8,080,081</u>	<u>\$ 3,343,785</u>	<u>\$ 15,846,266</u>	<u>\$ 27,270,132</u>
Investment return:				
Investment income	203,919	472,081	—	676,000
Net depreciation	<u>(1,877,980)</u>	<u>(491,824)</u>	<u>—</u>	<u>(2,369,804)</u>
Total investment return (loss)	<u>(1,674,061)</u>	<u>(19,743)</u>	<u>—</u>	<u>(1,693,804)</u>
Contributions	—	1,736	259,499	261,235
Appropriation of endowment assets for expenditure	(95,493)	(924,192)	—	(1,019,685)
Other changes –				
Change in value of split interest agreement	—	197,731	—	197,731
Net asset transfers	<u>—</u>	<u>(739,712)</u>	<u>739,712</u>	<u>—</u>
Endowment net assets, end of year	<u>\$ 6,310,527</u>	<u>\$ 1,859,605</u>	<u>\$ 16,845,477</u>	<u>\$ 25,015,609</u>

Mercyhurst University
Notes to Consolidated Financial Statements
May 31, 2012

Amounts of donor-restricted endowment funds classified as permanently and temporarily restricted net assets at May 31, 2012 consisted of:

Permanently restricted net assets – portion of perpetual endowment funds required to be retained permanently by explicit donor stipulation	<u>\$ 16,845,477</u>
Temporarily restricted net assets	
Portion of perpetual endowment funds subject to a time restriction	
With purpose restrictions	\$ 1,446,833
Without purpose restrictions	<u>412,772</u>
	<u>\$ 1,859,605</u>

From time to time, the fair value of assets associated with individual donor-restricted endowment funds may fall below the level the University is required to retain as a fund of perpetual duration pursuant to donor stipulation. In accordance with GAAP, deficiencies of this nature are reported in unrestricted net assets and aggregated \$2,093,616 at May 31, 2012. These deficiencies resulted from unfavorable market fluctuations, and continued appropriation for certain purposes that was deemed prudent by the Board of Trustees.

The University has adopted investment and spending policies for endowment assets that attempt to provide a predictable stream of funding to student scholarships and other programs supported by its endowment while seeking to maintain the purchasing power of the endowment. Endowment assets include those assets of donor-restricted endowment funds the University must hold in perpetuity or for donor-specified periods, as well as those of board-designated endowment funds. Under the University’s policies, endowment assets are invested in a manner that is intended to produce results that exceed inflation while assuming a moderate level of investment risk. The University expects its endowment funds to provide an average rate of return of approximately CPI plus 2% annually over time. Actual returns in any given year may vary from this amount.

To satisfy its long-term rate of return objectives, the University relies on a total return strategy in which investment returns are achieved through both current yield (investment income such as dividends and interest) and capital appreciation (both realized and unrealized). The University targets a diversified asset allocation that places a greater emphasis on equity-based investments to achieve its long-term return objectives within prudent risk constraints.

Mercyhurst University
Notes to Consolidated Financial Statements
May 31, 2012

The University has a policy (the spending policy) of appropriating for expenditure each year 4.5% of invested endowment assets using a rolling quarter average market value calculation through March 31st of the year preceding the year in which expenditure is planned. For the year ending May 31, 2012, the calculation was based on a rolling 20 quarter average market value. In order to fund the costs of the University's current capital campaign, the University amended the spending policy in November of 2009 to permit an additional 1.5% of invested endowment assets based on a rolling quarter average market value, as noted above, over each of the next 10 years subject to the annual amount shall not exceed one third of the funds raised for the endowment in cash and pledges during the previous twelve months. In establishing this policy, the University considered the long-term expected return on its endowment. Accordingly, over the long term, the University expects the current spending policy to allow its endowment to grow at an average of CPI plus 2% annually. This is consistent with the University's objective to maintain the purchasing power of endowment assets held in perpetuity or for a specified term, as well as to provide additional real growth through new gifts and investment return.

Note 6: Land, Buildings, and Equipment

Land, buildings, and equipment at May 31, 2012 consist of:

Land	\$ 3,934,567
Land improvements	9,928,838
Buildings	103,990,618
Furnishings and equipment	23,872,090
Library books	4,738,886
Construction-in-progress	<u>8,574,333</u>
	155,039,332
Less: accumulated depreciation	<u>58,397,568</u>
	<u>\$ 96,641,764</u>

Note 7: Disclosures About Fair Value of Assets and Liabilities

ASC Topic 820, *Fair Value Measurements*, defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Topic 820 also specifies a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

Level 1 Quoted prices in active markets for identical assets or liabilities

Mercyhurst University
Notes to Consolidated Financial Statements
May 31, 2012

Level 2 Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities

Following is a description of the valuation methodologies and inputs used for assets and liabilities measured at fair value on a recurring basis and recognized in the accompanying consolidated statement of financial position, as well as the general classification of such assets and liabilities pursuant to the valuation hierarchy.

Investments

Where quoted market prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. Level 1 securities include money market mutual funds, equity securities, U.S. Treasury securities and mutual funds. If quoted market prices are not available, then fair values are estimated by a third party pricing service using pricing models, quoted market prices of securities with similar characteristics or discounted cash flows. For investments, other than alternative investments, the inputs used by the pricing service to determine fair value may include one, or a combination of, observable inputs such as benchmark yields, reported trades, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers and reference data market research publications and are classified within Level 2 of the valuation hierarchy. Level 2 securities include real estate investments and certain trusts. For alternative investments that have sufficient activity or liquidity within the fund, fair value is determined using the net asset value (or its equivalent) provided by the fund and are classified within Level 2 of the valuation hierarchy. For alternative investments that do not have sufficient activity or liquidity within the fund, the net asset value (or its equivalent) provided by the fund is utilized, as a practical expedient, to determine fair value and are classified within Level 3 of the valuation hierarchy. Level 3 securities include hedge funds and private investment trusts.

Interest Rate Swap Agreement

The fair value is estimated using forward-looking interest rate curves and discounted cash flows that are observable or that can be corroborated by observable market data and, therefore, are classified within Level 2 of the valuation hierarchy.

Beneficial Interest in Charitable Remainder Trusts

Fair value is estimated at the present value of the future distributions expected to be received over the term of the agreement. Due to the nature of the valuation inputs, the interest is classified within Level 2 of the hierarchy.

Mercyhurst University
Notes to Consolidated Financial Statements
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The following table presents the fair value measurements of assets and liabilities recognized in the accompanying consolidated statement of financial position measured at fair value on a recurring basis and the level within the fair value hierarchy in which the fair value measurements fall at May 31, 2012:

	Fair Value	Fair Value Measurements Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Money market mutual funds	\$ 14,738,601	\$ 14,738,601	\$ —	\$ —
Beneficial interest in charitable remainder trust	575,978	—	575,978	—
Equity securities	1,392,723	1,392,723	—	—
U.S. Treasury securities	1,476,341	1,476,341	—	—
Equity mutual funds				
Index funds	3,963,191	3,963,191	—	—
Growth funds	1,653,412	1,653,412	—	—
Value funds	3,330,460	3,330,460	—	—
Blended funds	1,551,679	1,551,679	—	—
International funds	2,731,727	2,731,727	—	—
Fixed income mutual funds	7,923,265	7,923,265	—	—
Hedge fund-of-funds	1,924,152	—	—	1,924,152
Other investments	422,168	—	422,168	—
Interest rate swap agreement	(60,702)	—	(60,702)	—

Mercyhurst University
Notes to Consolidated Financial Statements
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The following is a reconciliation of the beginning and ending balances of recurring fair value measurements recognized in the accompanying consolidated statement of financial position using significant unobservable (Level 3) inputs:

	PA Stable Value Fund	Common Sense Fund
Balance, June 1, 2011	\$ 1,143,580	\$ 1,230,648
Total realized and unrealized gains (losses) included in change in net assets	(9,273)	9,197
Sales	(225,000)	(225,000)
Balance, May 31, 2012	\$ 909,307	\$ 1,014,845
 Total gains for the period included in change in net assets attributable to the change in unrealized gains or losses relating to assets still held at the consolidated statement of financial position date	 <u>\$ (76)</u>	

Realized and unrealized gains and losses are included in change in net assets.

Note 8: Accrued Expenses and Other Liabilities

Accrued expenses and other liabilities at May 31, 2012 consist of:

Accrued payroll	\$ 2,885,095
Accrued payroll taxes and withholdings	404,987
Accrued vacation	716,827
Other accrued expenses	121,992
	\$ 4,128,901

Mercyhurst University
Notes to Consolidated Financial Statements
May 31, 2012

Note 9: Long-term Debt

Long-term debt at May 31, 2012 consists of the following:

Notes payable	
Lines of credit	\$ <u>1,204,064</u>
Capital lease obligation	
Capital lease obligation includes a ten year lease covering washer and dryer equipment used in the University's dormitories and housing facilities. The lease expires in the year 2017	<u>126,371</u>
Bank Note	
Tax-exempt Qualified Revenue Note, Series of 2011, maturing at varying amounts through 2019, with interest at 1.405% at May 31, 2012 and at variable rates thereafter that are based upon 65% of LIBOR on each reset date, plus 1.25%	<u>9,600,000</u>
Bonds payable	
University Revenue Refunding Bonds Series A and B of 2004, maturing at varying amounts through 2023, with interest rates ranging from 4.849% to 5.00%	10,050,000
University Revenue Bonds of 2008, maturing at varying amounts through 2038, with interest rates ranging from 4.10% to 5.50%	<u>21,565,000</u>
Total bonds payable	<u>31,615,000</u>
Total long-term debt	\$ <u>42,545,435</u>

The University currently has two line of credit arrangements with two local banks that provide the University 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 May 31, 2014. 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 University, on parity with the Borrower's bondholders. On March 23, 2006, the University entered into a one year \$1,000,000 revolving line of credit for short term working capital with a bank to replace a line of credit with another bank which expired March 1, 2006. Borrowings on the line are unsecured and are a general obligation of the University. The line of credit expires on May 31, 2014. 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 May 31, 2012 the balance outstanding under the lines of credit was \$1,204,364.

Mercyhurst University
Notes to Consolidated Financial Statements
May 31, 2012

On October 1, 2004, the University issued \$13,225,000 University Revenue Refunding Bonds, Series A of 2004 and \$5,140,000 University Revenue Refunding Bonds, Series B of 2004 (collectively, the 2004 Bonds) through the City of Erie Higher Education Building Authority (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 University 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 June 1, 2008, the University issued \$21,970,000 University Revenue Bonds through the Authority. The 2008 Bond proceeds were used to finance a project consisting of (a) current refunding of all 1997 Bonds, (b) the financing of the construction of a four-story, approximately 100,000 square foot 320-bed residence hall on the University's Erie campus, (c) the financing of the construction of a two-story, approximately 22,000 square foot 75-bed residence hall on the University's North East campus, (d) the funding of a debt service reserve fund; and (e) the financing of the costs relating to the issuance of the 2008 Bonds. The 1997 Bond proceeds were used to finance a project consisting of (a) the acquisition of apartment buildings for student housing; (b) the completion and automation of the University's library; (c) the renovation of McAuley Hall; (d) the construction of additional University 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.

The University is subject to certain financial and reporting covenants under the 2004 and 2008 Bond issues. The University is in compliance with these covenants.

As part of the 1993, 1997, 2004, and 2008 Bond issues, the Authority entered into a Sublease and Security Agreement, a Supplemental Sublease and Security Agreement, a Second Supplemental Sublease and Security Agreement, and a Third Supplemental Sublease and Security Agreement (the Agreements) with the University. Pursuant to the Agreements, the University 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 2004 and 2008 Bonds.

The 2004 and 2008 Bonds are secured by all gross revenues of the University, subject to certain permitted encumbrances, and all existing and future equipment and fixtures of the University.

Mercyhurst University
Notes to Consolidated Financial Statements
May 31, 2012

On December 15, 2011, the University retired the 1999, 2001, and 2003 Variable Rate Bond Issues and issued a Tax-Exempt Revenue Note, Series of 2011 through the Authority with a local bank for the remaining outstanding principal of the three Variable Rate Bond Issues of \$9,600,000. The three Variable Rate Bond Issues funded various construction projects on the Erie and North East campuses as well as certain costs of issuing the bonds. The bank simultaneously issued the put option set forth in the note, thereby establishing the maturity date of the note at November 1, 2018. The University may request an extension of the maturity date through a written request to the bank no more than one year prior to the maturity date. Within ninety (90) days following receipt of such request, the bank shall provide the University with a written notice of its determination whether or not to extend the maturity date.

The mandatory redemption and sinking fund requirements to redeem or otherwise retire principal amounts of the 2004 and 2008 Bonds and the 2011 Tax-Exempt Revenue Note are as follows:

- *2004 Series A Bonds* – Ranging from \$975,000 in 2013 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 \$245,000 in 2013 to \$345,000 in 2020, \$315,000 in 2021, \$330,000 in 2022, and \$340,000 in 2023 at maturity.
- *2008 Bonds* – Ranging from \$420,000 in 2013 to \$1,480,000 in 2038 at maturity.
- *2011 Tax-Exempt Revenue Note* – Ranging from \$800,000 in 2013 to \$4,500,000 in 2019 at maturity.

Aggregate annual maturities and sinking fund requirements of long-term debt and payments on capital lease obligations at May 31, 2012:

	Long-term Debt (Excluding Leases)	Capital Lease Obligations
2013	\$ 2,440,000	\$ 35,820
2014	3,704,064	35,820
2015	2,585,000	35,820
2016	2,760,000	35,820
2017	2,845,000	35,820
Thereafter	28,085,000	8,955
	\$ 42,419,064	188,055
Less amount representing interest payments		61,684
		\$ 126,371

Mercyhurst University
Notes to Consolidated Financial Statements
May 31, 2012

Note 10: 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 University entered into an interest rate swap agreement for a portion of its floating rate debt. The agreement provides for the University 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 \$4,000,000 at May 31, 2012. Under the agreement, the University 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 11: Operating Leases

The University has various operating lease agreements primarily involving facilities, office equipment and vehicles. These leases are noncancellable and expire on various dates through the year 2018.

Total rental expense for 2012 was \$2,557,220.

Future minimum lease payments at May 31, 2012 were:

2013	\$ 1,720,035
2014	1,249,572
2015	783,449
2016	477,844
2017	213,320
Thereafter	<u>17,784</u>
	<u>\$ 4,462,004</u>

Note 12: Trusts Payable

The University administers a charitable remainder trust. 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 University's use. The portion of the trust attributable to the future interest of the University is recorded in the consolidated statement 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 University's consolidated statement of financial position. On an annual basis, the University 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 trust's inception which was 7.0% and applicable mortality tables.

Mercyhurst University
Notes to Consolidated Financial Statements
May 31, 2012

Note 13: Pension Plan

Retirement benefits are provided for University employees through the Teachers Insurance and Annuity Association University 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 University and plan participants make monthly contributions to TIAA-CREF and VALIC to fund retirement benefits through a defined contribution plan. Effective June 1, 2011, the plan eliminated VALIC as an investment manager eligible to receive new contributions under the plan. Plan participants with accounts at VALIC established new accounts at TIAA-CREF to continue to make monthly contributions and receive matching contributions from the University to fund retirement benefits. The plan covers a majority of all eligible employees. The University's share of the cost of these benefits for the year ended May 31, 2012 was \$1,323,424.

Note 14: Contingencies and Commitments

The University 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 consolidated financial position, change in net assets and cash flows of the University.

Note 15: 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 May 31, 2012 are available for the following purposes or future periods:

Institutional support	\$ 1,123,739
Instruction	1,116,974
Academic support	154,048
Scholarships	441,500
Plant operations and additions	2,280,935
Public service	<u>16,960</u>
	<u>\$ 5,134,156</u>

Mercyhurst University
Notes to Consolidated Financial Statements
May 31, 2012

Permanently Restricted Net Assets

Permanently restricted net assets at May 31, 2012 are restricted to investments in perpetuity, the income from which is expendable to support:

Institutional support	\$ 3,674,443
Scholarships	10,701,993
Instructional	2,298,832
Student services	108,000
Public service	<u>62,209</u>
	<u>\$ 16,845,477</u>

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.

Purpose of restrictions accomplished:	
Instructional activities	\$ 85,031
Public service	15,000
Academic support	3,828
Institutional support	195,356
Operation and maintenance of plant	39,416
Scholarships	<u>1,006,588</u>
	1,345,219
Plant fund expenditures (non-operating)	<u>31,402</u>
	<u>\$ 1,376,621</u>

Mercyhurst University
Notes to Consolidated Financial Statements
May 31, 2012

Note 16: Expense Summary

Expenses classified by natural classification are summarized as follows:

Salaries and wages	\$ 31,874,388
Fringe benefits	9,415,175
Contract services	10,143,574
Conferences and seminars	639,848
Meetings and events	817,038
Supplies	768,114
Travel	1,613,669
Repairs and maintenance	766,629
Utilities	2,072,416
Cost of sales for auxiliary enterprises	6,971,372
Bad debts	350,000
Rents and leases	2,557,220
Non-capital equipment	1,056,973
Interest on indebtedness	1,802,580
Insurance	842,324
Depreciation and amortization	4,476,493
Other	<u>5,263,202</u>
	<u><u>\$ 81,431,015</u></u>

Note 17: Functional Expenses

The University's expenses on a functional basis, allocating interest to the appropriate functions and identifying fundraising, are as follows:

Instruction	\$ 35,088,197
Public service	267,593
Academic support	3,047,052
Student services	14,367,897
Institutional support	12,107,945
Auxiliary enterprises	15,084,409
Fundraising	<u>1,467,922</u>
	<u><u>\$ 81,431,015</u></u>

Mercyhurst University
Notes to Consolidated Financial Statements
May 31, 2012

Note 18: Significant Estimates and Concentrations

Current Economic Conditions

The current economic environment presents colleges and universities with unprecedented circumstances and challenges, which in some cases have resulted in large declines in the fair value of investments and other assets, declines in contributions, student financial aid, enrollment revenue, governmental support, grant revenue, constraints on liquidity and difficulty obtaining financing. The consolidated financial statements have been prepared using values and information currently available to the University.

In addition, given the volatility of current economic conditions, the values of assets and liabilities recorded in the consolidated financial statements could change rapidly, resulting in material future adjustments in investment values, allowances for contributions receivable and the valuation of intangibles that could have an adverse impact on the University.

Note 19: Subsequent Events

Subsequent events have been evaluated through the date of the Independent Accountants' Report, which is the date the consolidated financial statements were issued.

Supplementary Information

Mercyhurst University
Schedule of Expenditures of Federal Awards
Year Ended May 31, 2012

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		\$ 298,577
Federal Pell Grant Program	84.063		7,074,445
Federal Supplemental Education Opportunity Grant	84.007		252,850
Federal Perkins Loan Program	84.038		2,722,510
Federal Direct Lending Program	84.268		30,409,878
<i>Pass-through from Pennsylvania Department of Education</i>			
Vocational Education Program	84.048	23-600-3115	176,418
Art-Based Teacher ED	84.116Z		1,250
Carpe Diem Academy	84.287c		<u>88,066</u>
Total Department of Education			41,023,994
Department of Labor			
<i>Pass-through from Pennsylvania Department of Labor</i>			
Trade Adjustment Act Program	17.245	23-600-3107	177,157
Camp Adventures	17.259	20100127	17,428
Intelligence in Security & Technology	17.268	251293830	3,088
<i>Pass-through from Pennsylvania Department of Labor & Dept of Public Welfare/Erie School District</i>			
TANF STARS Program		11-12-TANF-1209	<u>1,038</u>
Total Department of Labor			198,711
Department of Justice			
<i>Pass-through from Pennsylvania Commission on Crime and Delinquency</i>			
FBI Graduate Certificate in Counterintelligence		#MER1654601	48,328

Mercyhurst University
Schedule of Expenditures of Federal Awards (continued)
Year Ended May 31, 2012

Federal Agency/Pass-Through Entity/Cluster/Program	CFDA Number	Grant or Identifying Number	Amount
Department of Health and Human Services <i>Pass-through from Pennsylvania Department of Public Welfare/ Erie School District</i> Temporary Assistance for Needy Families – TANF Challenge	93.558	1011-TANF-1113	946
Executive Office of the President Office of National Drug Control Policy – HIDTA	95.001	G09WB0004A	4,488,923
Department of Defense Artifact and Sample Analysis	12.114		11,012
Vehicle Technologies	12.	H98230-11-C-1439	128,087
Russian Study	12.	H98230-11-C-1439	100,151
Patent Pending	12.	H98230-12-C-1396	<u>12,509</u>
Total Department of Defense			251,759
Department of Commerce NOAA Eastern Gulf of Mexico	11.460		76,377
Department of the Interior Anasazi Basket Analysis	15.511		22,507
Draper Laboratory	15.		30,415
George Mason University	15.		49,406
Jacob's Strategic Solutions	15.		<u>55,216</u>
Total Department of the Interior			157,544
National Science Foundation Glacial Lake Ojibway	47.050		11,262
Corporation for National & Community Service Learn and Serve America – Glisten Planning Grant	94.018		1,943
National Aeronautics and Space Administration NASA Volcanic Processes	43.AAA		15,412
Department of State ATA State Department Cooperative Agreement	19.7	SDSASD07CA002	<u>370,462</u>
Total			<u>\$ 46,645,661</u>

Mercyhurst University
Schedule of Expenditures of Federal Awards (continued)
Year Ended May 31, 2012

Notes to Schedule

1. This schedule includes the federal awards activity of Mercyhurst University 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 University provided no federal awards to subrecipients.
3. During 2012, the University distributed \$340,462 in Perkins Loans. Perkins Loans outstanding at May 31, 2012, including the portion distributed from University funds, totaled \$ 2,373,520.
4. The Federal Direct Lending Program consists of subsidized and unsubsidized Federal Loans (for students) and Federal PLUS Loans (for parents and graduate students). Federal statute requires that proceeds from Federal Direct Lending Loans (subsidized, unsubsidized, and PLUS) be disbursed to the University to be directly applied to students' accounts. New loans processed for students during the eleven month period ended May 31, 2012 were as follows:

Federal Direct Lending Program	
Subsidized	\$ 11,950,429
Unsubsidized	13,527,873
PLUS	<u>4,931,576</u>
	<u>\$ 30,409,878</u>

**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 University
Erie, Pennsylvania

We have audited the financial statements of Mercyhurst University (the University) as of and for the year ended May 31, 2012, and have issued our report thereon dated October 2, 2012. 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

Management of the University is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our audit, we considered the University's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the University's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the University's internal control over financial reporting.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the University's financial statements will not be prevented or detected and corrected on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses as defined above. However, we identified a certain deficiency in internal control over financial reporting described in the accompanying schedule of findings and responses as item 12-01 that we consider to be a significant deficiency in internal control over financial reporting. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the University'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*.

We also noted certain matters that we reported to the University's management in a separate letter dated October 2, 2012.

The University's responses to the findings identified in our audit are described in the accompanying schedule of findings and responses. We did not audit the University's responses and, accordingly, we express no opinion on them.

This report is intended solely for the information and use of the governing body, management and others within the University 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

October 2, 2012

**Independent Accountants' Report on Compliance with Requirements
That Could Have a Direct and Material Effect on Each Major Program and
on Internal Control Over Compliance in Accordance with OMB Circular A-133**

Board of Trustees
Mercyhurst University
Erie, Pennsylvania

Compliance

We have audited the compliance of Mercyhurst University (the University) with the types of compliance requirements described in the U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement that could have a direct and material effect on each of its major federal programs for the year ended May 31, 2012. The University'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 University's management. Our responsibility is to express an opinion on the compliance of Mercyhurst University 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; 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 the University'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 University's compliance with those requirements.

In our opinion, Mercyhurst University complied, in all material respects, with the compliance requirements referred to above that could have a direct and material effect on each of its major federal programs for the year ended May 31, 2012.

Internal Control Over Compliance

The management of Mercyhurst University is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts and grants applicable to federal programs. In planning and performing our audit, we considered the University's internal control over compliance with the 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 internal control over compliance in accordance with OMB Circular A-133, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of the University's internal control over compliance.

A deficiency in internal control over compliance exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance with a type of compliance requirement of a federal program on a timely basis. A material weakness in internal control over compliance is a deficiency, or combination of deficiencies, in internal control over compliance such that there is a reasonable possibility that material noncompliance with a type of compliance requirement of a federal program will not be prevented, or detected and corrected, on a timely basis.

Our consideration of internal control over compliance was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over compliance that might be deficiencies, significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses, as defined above.

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

BKD, LLP

October 2, 2012

Mercyhurst University
Schedule of Findings and Questioned Costs
Year Ended May 31, 2012

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:
Significant deficiency(ies) noted considered material weakness(es)? Yes No
Significant deficiency(ies) 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:
Significant deficiency (ies) noted considered material weakness(es)? Yes No
Significant deficiency (ies) 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 University
Schedule of Findings and Questioned Costs (continued)
Year Ended May 31, 2012

7. The Organization's major programs were:

Cluster/Program	CFDA Number
Student Financial Aid Cluster	84.033, 84.063, 84.007, 84.038, 84.268

8. The threshold used to distinguish between Type A and Type B programs as those terms are defined in OMB Circular A-133 was \$300,000.

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

Mercyhurst University
Schedule of Findings and Questioned Costs (continued)
Year Ended May 31, 2012

Findings Required to be Reported by *Government Auditing Standards*

Reference Number	Finding	Questioned Costs
12-01	<p>Criteria or specific requirement – Management is responsible for establishing and maintaining effective control over financial reporting.</p> <p>Condition – A construction invoice for work performed in the fiscal year was improperly recorded in the following fiscal year.</p> <p>Context – We noted formal review and approval for certain reconciliations, journal entries and year-end close processes did not occur.</p> <p>Effect – An audit adjustment was required.</p> <p>Cause – It appears no one other than the preparer reviewed the entry to record the construction invoice.</p> <p>Recommendation – We recommend the Finance Office implement more formal review procedures as a control to help ensure the financial integrity of the monthly and year-end financial statements.</p> <p>Views of responsible officials and planned corrective actions – Management inadvertently did not accrue the May payment application for the construction costs associated with the Center for Academic Engagement. The payment application was held for several months after year-end because documentation for certified payrolls and steel certifications from subcontractors were behind. The Finance Office has implemented steps in the monthly and year-end closing processes to assess the completion of outstanding construction projects to ensure necessary accrual entries are made to reflect the projects' completion status. Furthermore, the Controller and the Director of Finance will review journal entries prepared by the staff on a monthly basis.</p>	None

Findings Required to be Reported by OMB Circular A-133

Reference Number	Finding	Questioned Costs
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No matters are reportable.

Mercyhurst University
Summary Schedule of Prior Audit Findings
Year Ended May 31, 2012

Reference Number	Summary of Finding	Status
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No matters are reportable.