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PRESENTS

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A TALE OF TWO SED'S

LEASE ACCOUNTING

BOARD ANALYSIS

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GiGi's Playhouse™
Down Syndrome Achievement Centers
educate. inspire. believe.
Long Island, NY

BRINGING A UNIQUE UNDERSTANDING OF KEY ISSUES FACING THE SPECIAL EDUCATION SECTOR

CERINI & ASSOCIATES LLP
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GIGI'S PLAYHOUSE

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Down Syndrome Achievement Centers
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Long Island, NY

Our Why – To change the way the world views Down syndrome and send a global message of acceptance for all.

Our How – We change lives and provide hope through consistent delivery of free educational, therapeutic and career development programs for individuals with Down syndrome, their families, and the community, through a replicable playhouse model.

Our Goal – GiGi's is recognized as the global leader in creating opportunities for individuals with Down syndrome while building a more accepting world for all.

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A TALE OF TWO SED'S

When Charles Dickens wrote, *"It was the best of times, it was the worst of times,"* as he started his Tale of Two Cities, he could have also been writing about where the special education marketplace finds itself today.

There has been a shift in the political landscape where the Governor, the State Regents, the NY State Legislature, and more are finally recognizing the importance of independent special education schools and the lack of parity that has existed for more than a decade. They are much more receptive to hearing from the leaders within the industry, which could result in some positive conversation and results.

On the other hand, some providers, especially in NY City, are still struggling with low enrollment, lack of staffing, diminishing resources, and a high level of uncertainty. Furthermore, COVID related regulations come from many administrative agencies, with different guidance from each lead agency, so providers really need to work through many of the issues themselves in an effort to keep their staff and families safe.

Unlike Dickens, I am not clairvoyant. I do not have a crystal ball that allows me to divine how all the issues will play-out … all I can do is fill you in on what we know and where I think we should be going.

THE BEST OF TIMES …

1. In December, Governor Hochul vetoed the parity bill that would have aligned private special education schools with school districts, so annual increases would have been consistent across the educational spectrum. With the veto, providers are only entitled to the 4% increase that SED had presented to and received approval from the Division of Budget during the spring, as opposed to the 7% + that districts are receiving. The 4% increases will be retroactive to July 1, 2021 and should be paid out soon. While Governor Hochul vetoed the Parity Bill, she did promise an 11% increase for preschool and school-age special education providers during the 2022-23 year. Yes, this is a major increase, but if you consider how much more school districts received over the last decade, NY State has a long way to go to close the gap.
2. The NY State Regents and Governor seem to be more sympathetic to special education programs then in the past. As a result, now is the time to step up your organizational lobbying efforts. Many of the trade associations are stepping up conversations about:
   a. *Increased rate enhancements for private schools to gain true parity with districts on an on-going basis*
   b. *Create more flexibility within the continuum of special education to allow for a more truer least restrictive environment when and where it is needed*
   c. *Interim plus rates to ensure that even if a program is not reconciled (especially with all of the waivers out there) that they will get the cash flow from rate increases to be able to effectively run their programs.*
   d. *A movement to the 5 year reconciliation process that SED was advocating for a few years back. This will allow providers to smooth out spending issues brough about by enrollment and staffing issues.*
   e. *A change in the rate methodology that rethinks the 30% non-direct care screen, especially with the difficulty in attracting and retaining qualified staff and drops in related service delivery rates in a remote environment; coupled with increases in real estate costs.*

   f. *Educational staff enhancements that are being offered to School Districts also finding their way into the special education marketplace for private special education providers.*
   g. *Additional funding levels for teacher retention funds to allow providers to give more money to much needed staff.*
3. Don't forget that there are provisions (*which was finally issued on 2/15/22*) within the 2021/2022 rate methodology letter that have positive impacts on providers:
   a. *The 1% corridor which 853 schools have been enjoying for the last 5 or 6 years is now available to 4410 providers. In a nutshell, if your actually expenditures are within 1% of your allowable rate (greater of prior year trended forward or current prospective rate), your rate will not be reconciled, and as such shortfalls will not be recovered or overages are not appealable (can't file a waiver). If you are outside the 1% corridor, the rates will be reconciled as normal.*
   b. *The 7.5% enrollment decline provision. If your enrollment declines by more than 7.5% as compared to the 3 year average enrollment for fiscal 2017, 2018, and 2019, you may be entitled to an enhancement in your rate to cover losses incurred.*
4. Many New York City based providers have submitted applications for the UPK enhancement. While the enhancements will be awarded on a first come first serve basis, with preference given to providers that met the February 1st due date. The program is open until March 31, 2022 for any providers that are still interested. We are still unsure at this point how much of an enhancement the City will provide to approved providers.
5. In December, Governor Hochul signed the EI Covered Lives bill which eliminates the need to bill insurance carriers, and billing the State directly. This will have a significant decrease on the administrative burden that EI providers have in billing insurance companies. It is still uncertain as to when this new law will go into effect.

THE WORST OF TIMES …

1. Providers are still experiencing enrollment declines attributable to several reasons:
   a. *More people are working from home, which is delaying the number of children in daycare, resulting in children not being evaluated as timely.*
   b. *With district employees working remotely and staff shortages, there have been delays in paperwork and getting children into appropriate programs.*
   c. *With the federal mandates pushing towards least restrictive environment, many of the higher functioning children that would have found their way into 10:1:2 and 12:1:2 classes are being served within district classes.*
2. Staffing shortages continue to persist, and they will continue to deteriorate in the near future as staff continue to leave special education providers for the bigger pay-day of district employment. Until some level of pay parity is put in place, it will continue to be difficult for special education providers to compete with districts. Without incentives (*tuition/student loan subsidies*), pay increases (*special education providers are paying salaries equivalent to the lowest 5% of what districts are paying*), and other programs to increase the flow of teachers to special education schools, it will be increasingly difficult for providers to staff their classrooms.
3. COVID relief funds are drying up. While some providers that have applied for ERTC funds (*you have 3 years to file for relief*) are still waiting for the cash (*could take a year for the refund to come from the IRS*), it is unlikely that additional funding will be made available providers (*there is a bill circulating that would allow providers to apply for ERTC for the fourth quarter of 2021 if they are eligible*). As you know, PPP funds are considered offsetting revenue for tuition-based programs and could be recouped by SED if they result in underspending. SED is one of the few NY State agencies that is not allowing providers to keep their PPP funding.
4. There are currently no rate increases in the works for Early Intervention providers, who have gone nearly 20 years without additional funds. This is an issue that the various umbrella organizations are focused on rectifying.
5. The OSC continues to perform audits of 4410 providers and issue reports that disallow costs. What began as audits that were established to identify abuses within the industry, has, over the years, turned into the OSC's rather liberal interpretation of the RCM resulting in significant disallowances for such things as timing differences, misapplication of documentation and benefits standards, and more.

With the impact of the COVID pandemic on provider operations, we expect to see a large increase in the number of waiver requests by providers for enrollment drops, admin levels in excess of 30%, increases in intensity of classrooms and service needs of children and more.

The next year or so will go a long way in setting the tone for the future of special education providers. For too long, special education providers have not been seen in the same light as other education providers, even though these programs are an extension of district services dealing with some of the most needy and vulnerable children in the State. This is an opportunity for New York State to rectify more than 20 years of lack of consideration and focus on the education of these children in their most formidable years where real long-term savings to the State can be developed … but those are decisions for smarter people than me.

Just realize that you are making a difference, and while things are difficult, it is a far, far better thing that you are doing, than has ever been done. Thank you!

LEASE ACCOUNTING

BACKGROUND

For many schools, the largest non-labor cost is facilities. For years this has created some disparity in the comparability of financial statements between schools, as some schools own their facilities while others rent. Several years ago, the **Financial Accounting Standards Board ("FASB")** issued **new lease accounting standards ("ASC 842")** to try to align some of these issues across all industries and make financial reporting more consistent. The COVID pandemic has pushed off the implementation of ASC 842 for nonprofits and private companies without certain public debt. The deferral is unfortunately coming to an end with adoption required for years starting after December 15, 2021 (*calendar year 2022 or fiscal year 2023 entities*).

In a nutshell, ASC 842 will require most providers with real property or equipment leases to record both a right-of-use asset (*the present value of the future required lease payment stream*) and a corresponding liability to reflect, in essence, the asset and liability associated with the required future lease payments (*inclusive of renewal options and other provisions that management may anticipate taking advantage of*). By requiring assets and liabilities to be reflected on a school's financial statements, ASC 842 makes it easier for stakeholders to see a school's risk exposure and true financial position.

WHAT IS A LEASE?

A lease is defined as a contract or an element of a contract that conveys the **right of use ("ROU")** of a physically distinct identified asset for a specified period of time in exchange for payment. The asset can be real property, facilities and related improvements, furniture and equipment, or other tangible assets. The period of time isn't necessarily quantified by time but can also be described in terms of the estimated use of an asset, such as the number of units a piece of equipment will produce.

LEASE CLASSIFICATION

While substantially all leases are required to be capitalized on your statement of financial position or balance sheet, it is still necessary to classify leases as either finance leases (*previously referred to as capital leases under ASC 840*) or operating leases, because the two lease types are measured differently. Under ASC 842, a lease is considered a finance lease if it meets any one of the following criteria:

- ▶**Transfer of title test:** *By the end of the lease term, will ownership of the asset transfer from the lessor to the lessee?*
- ▶**Bargain purchase option test:** *Is there a purchase option in the lease that the lessee is reasonably certain to exercise?* (*i.e., the lessee can purchase the asset for $1*)
- ▶**Lease term test:** *Does the lease term encompass the major part of the remaining economic life of the underlying asset? ASC 842 removes the bright line test of 75% of the asset's useful life.*
- ▶**Present value test:** *Is the present value of lease payments plus residual value guaranteed by the lessee greater than or equal to substantially all of the fair market value of the asset? ASC removes the bright line test of 90% of the asset's fair market value.*
- ▶**Alternative use test:** *Is the asset so specialized that it is only useful to the lessee? Basically, the asset has no value to anyone else without a major overhaul by the lessor.*

Under an operating lease, the ROU asset is recorded and amortized to rent on a straight-line basis over the lease term, so from a statement of changes in net assets and income statement perspective, there will be little change in presentation. Finance leases require the lessee to recognize interest expense and amortization expense over the shorter of the asset's life or the lease term. As a result, you will usually recognize a greater expense earlier in the life of the lease for a finance lease. Furthermore, for those for-profit schools that track operations using **earnings before interest, taxes, depreciation, and amortization ("EBITDA")**, an operating lease reduces EBITDA while a finance lease does not.

CALCULATING THE LEASE LIABILITY UNDER ASC 842

Your lease liability is the current value of minimum future lease payments. To determine the liability, there are certain assumptions/estimates that need to come into play:

- ▶*If the lease contains a residual guarantee or use limits, what's the likely amount you will owe under such provisions (i.e., a vehicle lease that provides 10,000 miles per lease)?*
- ▶*If the lease contains certain options such as renewal options, termination options, or purchase options, what is the likelihood that you will exercise such options?*

These assumptions/estimates will impact your lease liability calculation. Keep in mind that the assumptions you make about lease options at the beginning of the lease can change over time. If, during the term of a lease, you change your mind about whether you are likely to exercise any lease options or there are material changes in residual guarantees or uses, you will need to remeasure both your lease liability and your ROU asset.

(CONTINUED ON NEXT PAGE)

The discount rate to use in calculating the lease liability is either the rate implicit in the lease (*if known, though it rarely is explicit*) or your organization's **incremental borrowing rate ("IBR")**. Nonpublic schools also have the option to use a risk-free rate. ASC 842 defines the IBR as, *"the rate of interest that a lessee would have to pay to borrow on a collateralized basis over a similar term an amount equal to the lease payments in a similar economic environment."* To put this in English, your IBR is the rate of interest you could borrow at under similar terms (*amount, length of time, etc.*). If you have a strong relationship with your banker, you should be able to obtain from your bank your IBR for each lease you enter into or some guide you can use for the year based upon your credit history, market conditions, length of borrowing, security, etc.

CALCULATING ROU UNDER ASC 842

The ROU asset is calculated as the lease liability, discussed above, plus or minus these adjustments:

- ▶ **Plus:** *initial direct costs and prepaid lease payments (a)*
- ▶ **Minus:** *lessor incentives, accrued rent, and ASC 420 liability at transition date (b)*

a. Examples of typical initial direct costs under ASC 842 include commissions and payments made to an existing tenant to incentivize that tenant to terminate its lease as these costs would only be incurred as a result of execution of the lease. Costs that typically would not be considered initial direct costs are legal fees, costs of negotiating lease terms, lease underwriting, or general overhead expenses such as depreciation, occupancy, and equipment costs, as these costs would be incurred regardless of whether the lease is ultimately executed.

b. ASC 420 required you to record a liability for the amount of above market rent you were paying over the life of the lease. Under ASC 842, this would reduce the carrying value of the ROU asset.

Over the life of the lease, the ROU is amortized using the straight-line method over the life of the lease.

EMBEDDED LEASES UNDER ASC 842

Since prior to ASC 842 operating leases were not capitalized, embedded leases had very little impact on your overall financial statements. After all, if a lease contained utility charges, tax pass-throughs, and other services such as admin support, *did it really matter?* It was all part of your occupancy costs on your statement of functional expenses or income statement. As you now have to capitalize leases under ASC 842, it becomes increasingly more important to ensure you are able to truly understand the terms of each agreement. As a result, you now need to:

- ▶ *Examine all contracts to find any embedded leases within them*
- ▶ *Separate the lease components (for use of assets) from non-lease components (payments for the service) within the contract*

The way your lease is written could significantly impact embedded leases. If your lease is a gross lease, whereby property taxes and common area costs (*i.e., snow removal*) are part of a fixed rate lease, ASC 842 provides for a practical expedient allowing these costs to be considered part of the lease, which means you don't need to separate out these costs before calculating your ROU asset. If, on the other hand, your lease is a net lease, whereby property taxes and other costs are variable and billed separately, these would be excluded from the lease and the calculation of your ROU asset. Even so, for schools that enter into collaborative agreements for space that includes such items as secretarial support, supplies for your students, fieldtrips, coverage, etc., you do have to go through the process of determining how much of the monthly payment is for the space cost and how much is for the additional services built into the agreement.

IMPACT OF COVID-19 ON LEASE ACCOUNTING

Pursuant to ASC 842, you need to evaluate your ROU asset as changes in lease terms, your intentions with respect to leases, use of assets, and more could have an impact on the carrying value of your ROU asset and related liability. The COVID pandemic and the push for more remote work and flexible work environments has significantly changed the way that many businesses, including schools, have looked at their operations and could also result in changes in lease terms, certain rental concessions, decisions to not renew or to cancel certain leases. Once ASC 842 is adopted, you will need to evaluate any lease related decisions (*real property and equipment*) and determine the impact that these decisions will have on the valuation of your ROU asset.

OTHER CONSIDERATIONS

Adoption of ASC 842 will dramatically impact many schools' statements of financial position or balance sheets, adding significant levels of assets and related debt. These changes in financial position will result in increased debt levels which could impact debt to equity ratios, liquidity ratios, and more. These could negatively impact debt covenants. Furthermore, many debt agreements put limitations on your ability to enter into debt without approval. As leases under ASC 842 now are reflected as an obligation on your statement of financial position, this could pose a problem for you every time you want to enter into an equipment or property lease. It is important for you to sit down with your bankers to work through changes in debt covenants with them in consideration of the impact of ASC 842. Similarly, the change to your statement of financial position could impact other stakeholders such as government funders, donors, your Board, and more. It is important to get ahead of the curve and discuss this with them before they are surprised by a dramatic change in your numbers.

CLOSING REMARKS

For those schools that own their own buildings and rent most of their equipment under finance leases, the impact of ASC 842 may not be significant, but for the rest of you, ASC 842 will dramatically change your financial picture. The calculations under ASC 842 are extensive and difficult, and application is retroactive, so it will impact not just the year of adoption, but the prior year (*opening net assets*) also. We encourage you to go through the analysis of all your leases now, before ASC 842 is required, to understand the full impact it will have, and to provide for appropriate time to work through this with the necessary stakeholders to avoid issues or surprises later. ASC 842 will provide a better picture of your commitments and obligations and provide greater transparency of your financial positions and obligations. This is a significant positive; however, it will also take some time to go through the implementation process and educate your financial statement users about the changes.

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BOARD ANALYSIS

Most school leadership, from executive management to the Board, are extremely focused on ensuring students are getting a strong education that will allow them to get into the top-tiered colleges, looking to develop strategies towards new modes of learning, and finding more effective ways to align teachers and learning. The education of students has to take priority in everything you do as a school leader, which continues to evolve in today's *"classroom."* While very important, I find that school leaders often don't have a strong understanding of some of the operational risks that arise in school management. Being able to process information and assess risk is also critical in the long-term well-being of the school you manage.

The changing landscape of education, the myriad of new government regulations and funding, the uptick in technology usage, the impact of inflation, your sources of funding and corresponding donor restrictions, and the processes you have in place, all impact the viability of your organization. Unfortunately, comprehensive risk assessments, which should happen at the audit committee and management level, are not effectively taking place to identify and asses the potential risks and what the impact to the organization may be.

There is risk in every decision we make, and we have gotten to the point where we can often assess simple risks quickly and effectively so that we are not paralyzed by indecision. We draw upon our life experiences to guide us through situations, and we also rely on our management team and fellow Board/Audit Committee members to consider avenues we may not have thought about … because truthfully, we really don't know what we don't know. Having said that, it is also important to think strategically about the organizations that we manage and consider *"What can go wrong, and do we have processes in place to identify and correct things if they do go astray?"*

Nonprofit Boards have certain fiduciary duties in place, the Duties of Care, Loyalty, and Obedience … these duties also hold true for organizational management. Fulfillment of these duties requires organizational leadership to consider organizational risk:

- ▶ Are proper controls in place to safeguard the school's resources?
  - ▷ *Are proper IT controls in place to prevent cyber theft and are staff receiving proper training?*
  - ▷ *Are access controls appropriate to ensure confidentiality of information (e.g. FERPA regulations)?*
  - ▷ *Are proper backup and recovery in place?*
  - ▷ *Is there an effective system of internal controls in place that blends prevent controls (segregation of duties) and detect controls (compensating controls)?*
  - ▷ *Is there adequate insurance coverage and are insurable risks properly considered?*
- ▶ Are the organization's assets being deployed in an efficient manner?
  - ▷ *Are expenditures properly being monitored (budget to actual) and periodically readjusted if necessary?*
  - ▷ *Are investments prudently managed and are processes properly documented as required by the* ***New York Prudent Management of Institutional Funds Act (NYPMIFA)***
- ▶ Is staff effectiveness properly being analyzed and reviewed?
- ▶ Is the organization maximizing its potential?
  - ▷ *Is the school meeting educational standards?*
  - ▷ *Is proper strategic planning in place to provide an appropriate roadmap for the school going forward?*
  - ▷ *Are established goals being met and how is their progress being monitored?*
  - ▷ *Does the school have an adequate flow of resources to meet budget and future growth plans?*
- ▶ Are there conflicts at the Board, management, donor, or other levels that may be negatively impacting the organization's growth or decision making?
- ▶ Is the school staying true to its mission and purpose?
- ▶ Is the school complying with appropriate laws and regulations?
  - ▷ *Nonprofit Revitalization Act*
  - ▷ *NYPMIFA*
  - ▷ *Payroll and Employment Laws*
    - ▷ *Is someone regularly reviewing employee handbooks, policies, and benefits?*
  - ▷ *Donor/Grant restrictions*
    - ▷ *Are endowments properly being tracked based upon donor intent or if donor intent is not clear, NYPMIFA?*
  - ▷ *Operational regulations (e.g. vaccine policies, etc.)*
  - ▷ *Funding source regulations, such as SED, Food Programs, etc.*
- ▶ What is the school doing to stay on top of changing regulatory changes and who is responsible for this?

This needs to be an ongoing process throughout the year, with assessment and monitoring occurring regularly within your organization. School leadership needs to work with internal and external stakeholders to identify and understand the various risks in place and develop an ongoing plan to continue to understand new risks, mitigate current risks, and monitor that policies and procedures are effectively working. There should be regular time set aside at management and Board/Audit Committee meetings to focus on risk and the actions the school will take.

There is so much that organization leadership needs to understand, and it is extremely difficult to juggle all the responsibilities. We have found that it has been harder for school leadership to think strategically, especially under the COVID pandemic, as the landscape has been changing so dramatically and leaders have had to react quickly to such changes. It is extremely important for leadership to come together (*management and Board*) to ensure that risks are properly addressed and assessed on an on-ongoing basis so that the education of tomorrow's leaders can continue.

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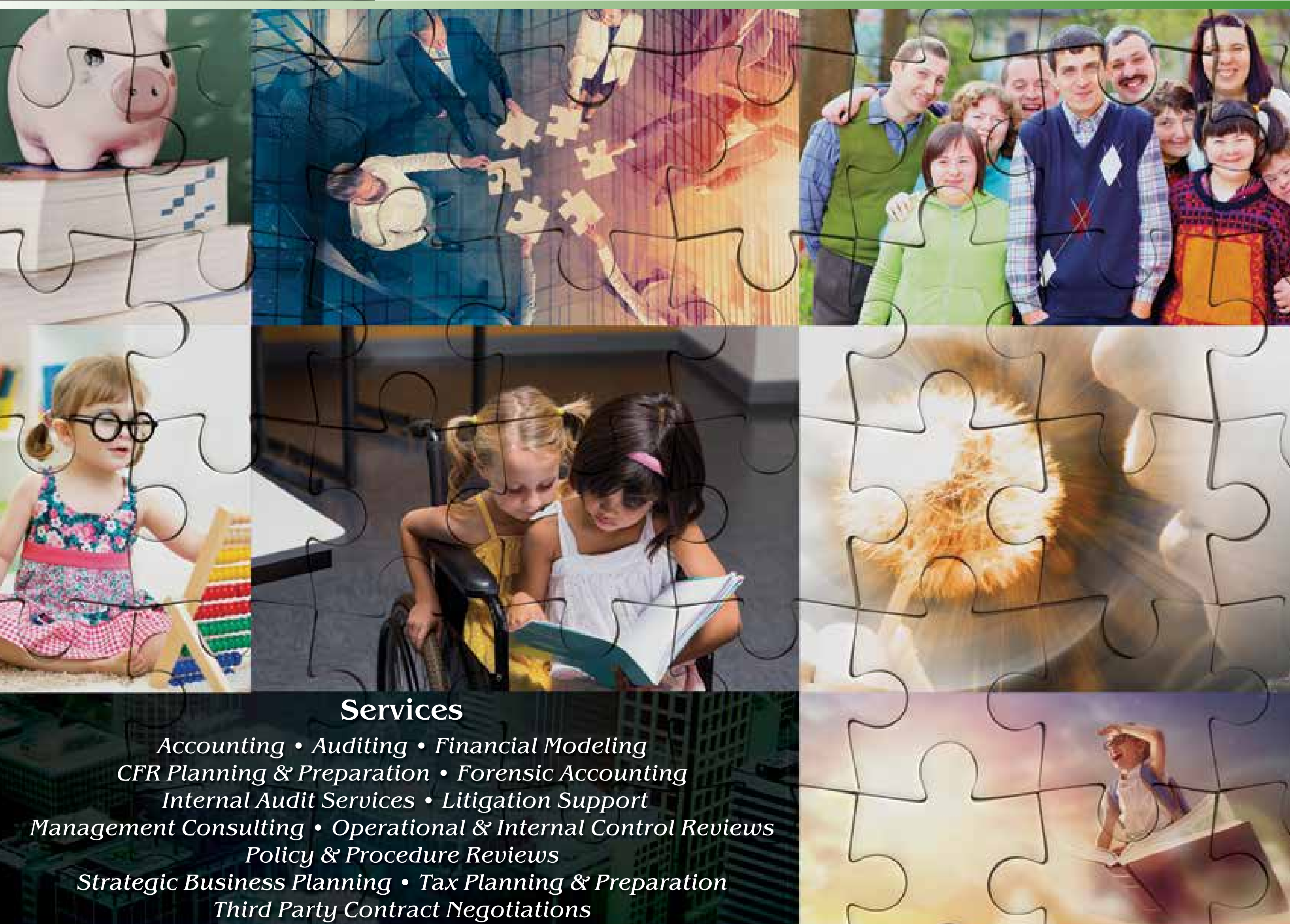

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