March 2006

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Hot Topic in Higher Education

Changes in Audit Guidelines for Alternative Investments Held by Higher Education and Not-for-Profits Highlight Risks of These Strategies

Moody's Emphasizes Strength of Management and Governance Practices

Summary

As higher education and other not-for-profit organizations have continued to shift increasingly large shares of their investment portfolios into alternative investments[1], Moody's has highlighted regularly the risks and opportunities associated with these strategies[2]. Recently, the American Institute of Certified Public Accountants (AICPA) published a new interpretation of SAS 101, the primary guideline for auditing investment fair value measurements and disclosures. Based on this new interpretation of existing audit standards and accounting practices, several changes to financial reporting are possible for higher education institutions, including, in certain circumstances restating investments at cost rather than market value, or requiring the consolidation of previously distinct corporate entities. Under certain circumstances, qualified audit opinions or scope limitations may be applied by auditors that cannot gain sufficient comfort in the values reported.

Moody's believes our existing approach to analyzing these alternative investments addresses the concerns and issues driving and raised by the auditing changes, but recognizes the significant challenges associated with analyzing fair values of these sometimes opaque investments. The increased level of scrutiny by auditors highlights the significant expertise, cost and time associated with diligent monitoring of these investments. Moody's believes the appropriate commitment of resources to manage alternative investments, in terms of cost, time and expertise, may be beyond the capacity of some smaller endowments unless they add staff and consulting expertise to supplement their traditional reliance on a few key board members to oversee their investments.

Our analysis of institutions with alternative investment portfolios will continue to weigh the liquidity, valuation and other risks inherent in alternative investment strategies, while simultaneously recognizing the unique characteristics of each organization we rate. These unique characteristics include the traditional measures of diversification across strategies and managers, along with the organization's investment management practices at both the management and board levels. We will also continue to make necessary adjustments to the financial statements that ensure comparability among organizations.

1. *Alternative investments can include a wide range of investment strategies, such as all manner of hedge funds, private equity, venture capital, real estate, and natural resources. For the purposes of this publication, our definition will include any investment structured as a limited liability corporation or partnership.*
2. *See publication of August 2004, "Risks and Opportunities of Hedge Fund Investments by Higher Education and other Nonprofits".*

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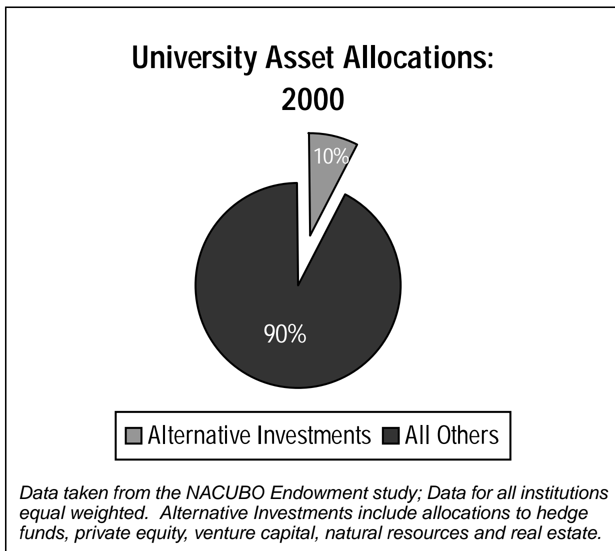
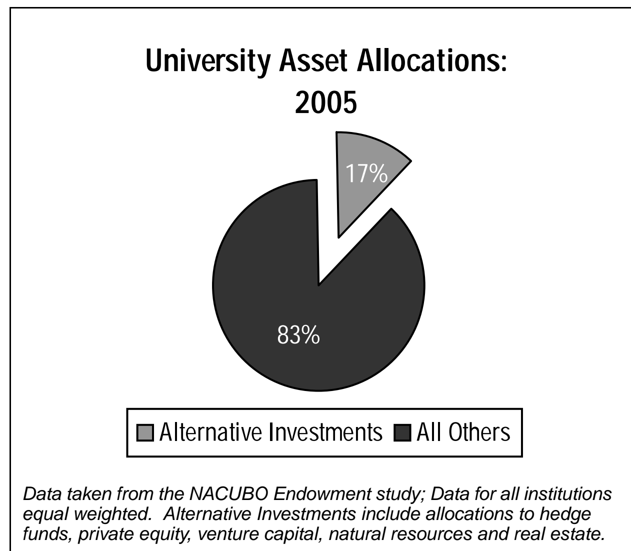
Any adjustments to financial statements (due to the auditing and accounting changes) will likely surround the issue of reported market value. For organizations that report investments at cost, we will continue to adjust assets to the market value disclosed in the financial statements in our quantitative calculations. However, we will engage in a discussion with management and when appropriate with the auditors to understand the rationale for cost based reporting. Organizations whose audit opinions are qualified or limited in scope due to the auditor's inability to verify valuations will be reviewed on a case by case basis. While a qualified opinion or scope limitation will not directly result in rating changes, Moody's will review the importance of the underlying investment to the overall credit quality of the organization. If the investment is a substantial part of the organization's liquidity, rating implications will be possible. Moody's greater concern for qualified opinions are other ramifications for organization's with qualified audit opinions, ranging from covenant violations in bond documents, accreditation reviews, and potentially eligibility for federal financial aid. These potential consequences of a qualified opinion could be significant and could directly impact credit quality if they snowball beyond simply an accounting issue.



Data taken from the NACUBO Endowment study; Data for all institutions equal weighted. Alternative Investments include allocations to hedge funds, private equity, venture capital, natural resources and real estate.



Data taken from the NACUBO Endowment study; Data for all institutions equal weighted. Alternative Investments include allocations to hedge funds, private equity, venture capital, natural resources and real estate.

Key Risks and Opportunities of Hedge Fund and Other Alternative Investments

Risks:

- Execution or Operational Risk: Risk of investment loss arising from inadequate internal processes, systems and staffing of investing organization or of investment manager
- Diversification Risk: Risk of investment loss caused by poor performance by a single fund or manager
- Liquidity Risk: Risk of insolvency due to illiquidity of investments in a cash-flow crisis

Opportunities:

- Superior investment performance: Diversification through various strategies along with exploitation of less efficient markets could enhance performance.
- Reduced volatility: Benefit of increased stability of investment performance by shifting to investments that are less correlated with publicly traded securities.

Auditing Change Highlights Difficulty In Assessing Fair Value Of Non-Public Investments:

Moody's credit analysis for higher education institutions incorporates a substantial review of liquidity and financial resources.[3] In addition, we place significant weight on benchmarking and comparative data amoung similar organizations. Higher education and other not-for-profit organizations have the option of reporting certain investments at either fair value or cost. For the few organizations that have chosen to report alternative investments at cost, Moody's historically has adjusted these values in our ratio calculations to the disclosed fair value of the investment. This adjustment ensures comparability between similar organizations and more accurately reflects the credit strength of the organization. Even if recently refined auditing standards lead to a greater number of institutions reporting investments at cost, Moody's will continue to make this adjustment.

3. For more information on Moody's analytic approach to public and private higher education and not-for-profit institutions, including definitions of our financial ratios, please refer to our published methodology reports detailed at the end of this report.

The revised auditing standard places a greater burden on the auditor to verify reported fair values of investments and does not allow for a confirmation from the fund manager as the sole verification (which had previously been sufficient). Under most circumstances, the auditor will be able to gain sufficient information on any fund that has an audited annual report or that discloses holdings which are publicly traded. Even if an audited financial statement is not available, the auditor may be able to apply certain standards and practices including a review of the methods used to determine values of non-marketable investments in order to assess the fair value of the investment. If the not-for-profit organizations's auditor cannot determine a fair value based on the audit standards, the audit report may be completed with a qualified opinion or a scope limitation, assuming the investment in question is material. Moody's believes this result will be fairly rare, but may be more likely to occur for those institutions that invest in funds whose managers are determined to maintain a high level of confidentiality around their investment strategy and for an institution whose investment is a relatively small portion of the overall fund (meaning the organization may have little leverage to persuade the fund manager to cooperate and provide sufficient information to the auditor). The valuations are complicated by the common situation where an investment's fiscal year end is different than the organization's.

Qualified Opinions And Scope Limitations

In circumstances of a qualified opinion or scope limitation, Moody's continued approach will be a full analysis of the investment practices of the institution, including governance structures, manager selection practices, and investment and conflict of interest policies. In addition, we will speak with the management of the organization and closely review the auditor's report to determine any specific effect on our ratio and credit analysis from the investment(s) whose value cannot be verified.

The most likely outcome will be to incorporate the values as reported into our ratios, but qualitatively asses the additional risk to the credit given the uncertainty associated with this particular investment. This outcome would clearly signal that the institution is investing in strategies that require significant oversight and investment expertise, increasing the importance of appropriate governance and investment practices. If the investment accounts for a substantial portion of the liquidity of the organization, or implies significant control and governance challenges, there could be downward pressure on the rating. Moody's expects a limited number of qualified opinions due to these issues. However, consequences of a qualified opinion could be broad including tripping bond covenants, raising concerns for accrediting bodies and possibly jeopardizing eligibility for federal financial aid. Our review of an organization with a qualified opinion will include the risk of the event snowballing into a much larger and more serious credit issue.

Alternative investment strategies are wide ranging in variety. Underlying investments range from holdings in liquid markets of Treasuries and publicly traded equities to stakes in small private companies and complex derivatives. Similarly, the legal structure, management and governance of these funds can vary considerably. Investment holdings that trade in these liquid markets, but use both long and short positions, derivative strategies and other tools not often available in traditional equity funds (often called marketable alternatives), are somewhat simpler to value. Other alternative strategies, such as private equity, venture capital and certain real assets, can be more challenging to value. These investments are by definition more illiquid and the investment manager and auditor may have little comparative information for these types of investments. In these cases, investment managers are often making a variety of assumptions about discount rates, possible acquisition values and other variables to arrive at a market value of the fund's stake in a particular investment.

As discussed in our previous reports, management of investments in these types of funds and strategies requires significant expertise and oversight. Some of the most professional endowment management teams are fully versed in the valuation methods used in each investment the endowment has made, fully understanding the assumptions of their investment managers. Many of the most sophisticated endowment managers already require full disclosure of underlying investments and maintain their own methods for verification of reported values as part of their ongoing due diligence, risk management, and manager selection procedures. These organizations are much less likely to encounter difficulty in providing evidence of fair value to the auditors. Smaller endowments, which frequently have very limited staff dedicated to investment management, and often rely on board members to review investment managers and strategies, are more likely to encounter difficulty in the fair value verification process. In some discussions with higher education organizations, Moody's has discovered little direct understanding of the underlying strategies of funds in which the endowment invests, as well as minimal review of the valuation methods and even legal structure of the investment. These situations are ripe for significant restatement of values or fund "blow-ups."

Consolidation Of Investment Corporations Expected To Be Limited, And Most Likely For The Largest Endowments:

Under the revised auditing standard, some investment corporations or partnerships that had previously been treated as distinct entities could be considered "controlled" by the organization and therefore consolidated in the university's audit. A likely example would be a limited partnership investment in which the organization holds more than 50% of the fund, but has historically not actually exercised any control over the management of the fund. This circumstance is most likely for some of the largest endowments that have taken significant stakes in new funds or have close relationships with the managers of the fund. Primary triggers for this type of consolidation will be the percent ownership of the fund and the legal structure of the partnership or corporation, focusing on the ability to exercise influence and control over the operations of the fund (not necessarily whether the influence has been practiced).

In cases where a consolidation occurs, Moody's will adjust the balance sheet to limit the effect of the consolidation to reflect only the university's stake in the fund or corporation. Consolidation is not expected to impact the analysis of annual operating performance based on the statement of activities.

Conclusion

While auditing and accounting treatment of alternative investments are changing, our fundamental approach to analyzing these investments addresses the concerns raised by the evolving auditing standards. Namely, we will continue to review an organization's investment management and governance practices while weighing the risks and opportunities associated with alternative investments. Universities and other non-profits without sufficient resources to invest in appropriate investment monitoring remain our greatest concern. Our financial statement adjustments will seek to maintain comparability between like organizations while placing appropriate weight on the risks highlighted by these auditing and accounting changes.

Related Research:

Special Comments:

Moodyís Approach To Analyzing Governance Of Private Higher Education And Not-For-Profit Organizations, December 2004 (89757)

Risks and Opportunities of Hedge Fund Investments by Higher Education and other Nonprofits, August 2004 (88439)

FASB Proposes to Allow Companies to Elect Fair Value Accounting – A Step in the Right Direction or a Stumble into Non-comparability? February 2006 (96568)

Moody's Rating Approach for Not-for-profit Cultural Institutions, November 2004 (89653)

Rating Methodologies:

Moody's Rating Methodology for U.S. Public Colleges and Universities, December 2002 (76899)

Moody's Rating Approach for Private Colleges and Universities, September 2002 (75753)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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Report Number: 96873

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