Higher Education Update

Implications of the Economic Downturn for Higher Education

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The full impact of the current economic turmoil is yet to be determined, although many issues related to accounting and financial reporting – more specifically, issues related to investment holdings and various credit arrangements – recently have come to the fore. Authors Brian Archambeault and Cynthia Pierce discuss four major implications that colleges and universities would be wise to consider.

Fair Value Reporting of Investments

Most investments are currently reported at fair value based on market quotations or prices, with unrealized gains and losses reported immediately in the financial statements. When significant changes in the fair value of the investments take place between the reporting date and the date of an auditor's opinion, an organization should consider making disclosures about unrealized losses, whether temporary or permanent in nature, incurred after the statement of financial position date.

For investments reported at estimated amounts that approximate fair value, determining significant changes in value might be more difficult. Management and auditors alike should be cognizant of any interim information from investment advisers or fund managers and should consider disclosing significant changes or issues that might affect investment valuation.

The fair value of bonds from the Federal Home Loan Mortgage Corporation (Freddie Mac) and Federal National Mortgage Association (Fannie Mae) also appears to be uncertain, as do collateralized mortgage obligations or other mortgage-backed securities. The stock value of these companies has been affected by the installation of a conservator over these funds; however, the impact on the bonds has yet to be determined. Entities holding a large number of such bonds might need to provide additional disclosures about related risks.

Events occurring after the balance sheet date but before financial statements are issued might need to be reflected in the financial statements, through either adjustment to or disclosure in the financial statements. Such events include significant changes in fair value or changes in liquidity leading to a violation of debt covenants.[1]

If subsequent declines are quantifiable and material, full disclosure in the notes to the financial statements should be considered. Otherwise, a general disclosure of risk associated with the current marketplace, such as this, could be included:

> The various investments in stocks, securities, mutual funds, and other investments are exposed to a variety of uncertainties, including interest rate, market, and credit risks. Due to the level of risk associated with certain investments, it is possible that changes in the values of these investments could occur in the near term. Such changes could materially affect the amounts reported in the financial statements of the organization.

Investment Liquidity

In September 2008, Wachovia Bank notified organizations participating in the Common Fund's Short Term Fund (the Short Term Fund) of its decision to terminate the fund and initiate procedures for an orderly liquidation of fund assets. It is believed that approximately 1,000 educational entities, with a total of $9.3 billion invested in the Short Term Fund, have been directly affected by this decision. Many institutions have used the Short Term Fund like a checking account for years, but Wachovia's action prevented each organization from being able to liquidate or withdraw funds from its account. The end result of these restrictions on withdrawal will undoubtedly be hardships for many institutions that have long relied on the fund's liquidity to meet current operating needs.

Educational entities and their auditors should consider the potential effects of this development on the financial statements of entities that participated in the Short Term Fund, or in any other investment funds with new restrictions on withdrawals. Financial statements to be issued for the year ended May 31 or June

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30, 2008, are particularly worthy of concern. Areas of consideration include:[2]

- **Balance Sheet Classification** – Investments may not qualify as "cash and cash equivalents," in accordance with Paragraph 8 of the Financial Accounting Standards Board Statement No. 95, "Statement of Cash Flow." If a classified balance sheet is not prepared, such withdrawal restrictions should be considered in determining the sequencing of assets on the balance sheet or disclosures in the notes to financial statements that provide relevant information about the liquidity or maturity of assets.

- **Financial Statement Disclosure** – The limitations on liquidity could lead to risks and uncertainties pertaining to certain significant estimates, such as measurement, liquidity, and violation of debt covenants, as well as vulnerability from concentrations of investments in volatile markets. Entities should consider whether to make disclosures (beyond those required or generally made in financial statements) in their financial statements about the risks and uncertainties resulting from such events and existing as of the date of the financial statements.[3]

- **Compliance With Debt Covenants** – The classification of investments could trigger violations of debt covenants. If a covenant violation occurs, issuers of debt should consider whether it triggers classification of the debt liability as current.

- **Going Concerns** – The inability to withdraw funds might jeopardize an organization's ability to meet current obligations, thus creating doubt as to the organization's ability to continue.

Remarketing of Variable-rate Bonds

Based on current market conditions, the ability to remarket (sell) bonds at auction could be in doubt. If such bonds cannot be remarketed, many such agreements must revert to the underlying letters of credit that guarantee the bonds. In this event, the debt is no longer payable under the terms of the bond agreement but rather is payable under the terms of the letter of credit agreement. This change could substantially affect the requirements for repayment and overall cash flow. In these situations, it is important to determine if the entity is subject to such remarketing and if more stringent repayment terms would cause significant financial hardship to the organization. [4]

A suggested disclosure for such a situation might read as follows:

> Pursuant to this agreement, the organization has agreed to certain financial and operating covenants, the more restrictive of which relate to the debt-servicing ratio, unrestricted cash and liquid investments, and unrestricted net asset requirements. As the bond issue described above operates in a floating rate mode and is remarketed at par value weekly, carrying value approximates fair value of the outstanding balance of the bonds. In the event the remarketing agents are unable to remarket the bonds, the bonds become a demand note under the letter of credit and require repayment under the terms of the letter of credit.

Fair Value of Interest Rate Swaps

In an attempt to reduce the impact on floating-rate debt of changes in interest rates, many organizations have entered into interest rate swap agreements. While these agreements have long provided organizations with stable interest rates, the current marketplace puts the effectiveness of interest rate swaps in doubt.

Determining fair value of interest rate swaps has long been an area of complexity because of the subjectivity involved in determining fair value. With the changing financial markets, the marketability of such swaps could be greatly affected, thus affecting the estimate of fair value. As a result, management and auditors should be cognizant of any significant changes in the valuation of these swaps after year-end reporting periods.

Managers and auditors should seek updated valuations of interest rate swaps from financial institutions to

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determine if significant changes have occurred related to outside market factors. Similar to declines in the fair value of investments, consideration should be given to disclosing significant fluctuations in swap values as a subsequent event. In addition, with the downfall and bankruptcy of many major investment banking companies, organizations should be especially aware of any call features that might exist within their swap agreements that could put the organization at risk of losing the swap or could require substantial payments to the swap holder. When call features have been exercised, organizations should consider the impact on current cash flow, the organization's ability to meet current obligations, and the related impact on the disclosures in the financial statements.

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[1] AU section 560, "Subsequent Events," http://72.3.243.42/project/subsequent_events.shtml, provides guidance pertaining to subsequent events; Topic D-11 of the Emerging Issues Task Force's "Impact of Stock Market Decline," discusses matters pertaining to certain subsequent events.

[2] "American Institute of Certified Public Accountants, "Liquidity Restrictions," www.aicpa.org/download/acctstd/TIS1100_15.pdf. This nonauthoritative Technical Practice Aid (TPA) addresses the potential accounting and auditing implications when a fund or its trustee imposes restrictions on a nongovernmental entity's ability to withdraw funds from a money market fund or other short-term investment vehicle. Among the topics covered by the TPA are balance sheet classification, disclosures, debt covenants, subsequent events, and going-concern considerations.

[3] AICPA Statement of Position 94-6, "Disclosure of Certain Significant Risks and Uncertainties," provides guidance to disclosures about these risks and uncertainties. *AICPA Technical Practice Aids,* ACC sec. 10,640.

[4] Ibid.

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