Insights on...

AUDITING ALTERNATIVE INVESTMENTS

AUDITING ALTERNATIVE INVESTMENTS

Understanding and Applying the AICPA's Practice Guide

The task of auditing alternative investments reported in a financial statement is becoming increasingly complicated. To help you better understand how to make the auditing process go more smoothly, Northern Trust hosted a panel discussion with a distinguished group of auditors, institutional investors and plan administrators. The following panel members contributed to this discussion:

- **Strother Asquith**, Director of Investment Administration, St. Jude Children's Research Hospital
- **Amanda Nelson**, Partner – Department of Professional Practice, KPMG
- **Debbie Smith**, National Partner – Employee Benefit Plan Assurance, Grant Thornton LLP
- **John Stomper**, Partner – Assurance and Enterprise Risk Services, Deloitte and Touche LLP
- **Peggy A. Bradley**, Vice President and Product Consultant – Worldwide Operations & Technology, Northern Trust

GROWING USE OF ALTERNATIVE INVESTMENTS

In managing today's diversified portfolios, investment committees increasingly allocate a portion of their investments to a variety of alternative assets including hedge funds, private equity, real estate, commodity funds and venture capital. This has caused a surge in the number of alternative investment funds available to investors.

Hedge funds, in particular, are growing considerably. Investors now have access to a record number of hedge funds representing approximately $1.5 trillion worldwide, according to Hedge Fund Research. Likewise, private equity fundraising continues to be at record levels, with U.S. institutional investors responsible for the majority of the global growth (see Figure 1: *Private Equity Fundraising in the United States* on page 2).

CONTINUED

"Alternative investments present unique challenges for both the auditor and the investor. Proper documentation of internal control procedures is essential to providing the auditor with sufficient audit evidence over the existence and valuation assertions."
Amanda Nelson, partner – department of professional practice, KPMG, and chair of the AICPA alternative investment task force

U.S. private equity managers have raised $1.3 trillion in commitments since 1997, with the vast majority (62%) committed to buyout funds. Venture capital funds received around 20% and funds of funds approximately 10%. Most of the commitments came from pension funds and other institutional investors.

One of the challenges alternative investments present is how to accurately determine their value. As a result, the number of accounting pronouncements and auditing standards investors, plan administrators and their auditors must follow has increased dramatically.

AICPA AUDIT PREPARATION GUIDANCE

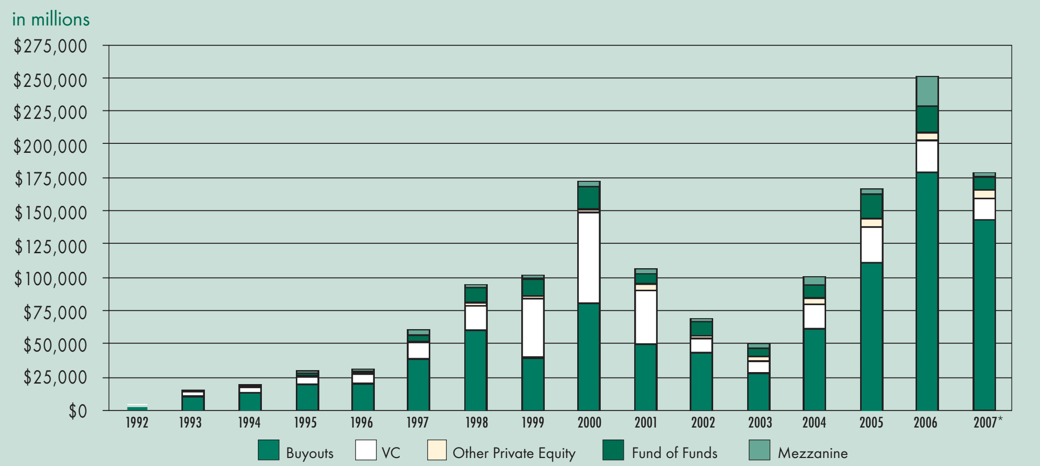
In 2006, the American Institute of Certified Public Accountants (AICPA) issued *Alternative Investments – Audit Considerations: A Practice Aid for Auditors*, to provide guidance on how to address the challenges associated with auditing investments for which a readily determinable fair value does not exist. Though this audit guide was initially produced for auditors, it is an important source of information for investors and plan administrators as well. Reading and understanding the Practice Aid is a very important first step in preparing for an audit.

As outlined in the Practice Aid, the auditor's role is to develop an audit approach based on an assessment of the risk of material misstatement of the financial statements. The auditor is likely to consider four key areas in assessing risk:

1. The significance of alternative investments to the financial statements;
2. The nature, complexity and liquidity of the underlying investments;
3. The nature and extent of management's process and related internal controls associated with valuation of alternative investments; and
4. The nature and extent of information available to management to support its valuation process and valuation conclusions.

As with all investments, the Practice Aid states investor management is responsible for all alternative investment valuation information included in the investor's financial statements. This

FIGURE 1: PRIVATE EQUITY FUNDRAISING IN THE UNITED STATES



Source: *Private Equity Analyst* magazine.

*Through September 26, 2007.

responsibility is absolute – it cannot be shared with investee management or any third-party service provider. The Practice Aid did not expand the role of the auditor beyond confirming the existence and value of an investment with the fund manager; rather it emphasized that the auditor should gain comfort with the existence and valuation of these investments based on the process and procedures followed by management.

DOCUMENTATION CRITICAL TO AUDIT SUCCESS

Investor management must clearly understand the funds in which it is invested, each fund's underlyings and the process each fund manager uses for its fund's valuation. Management must document that it has an effective process in place to gain this understanding, and also must have in place internal controls that include procedures for due diligence before making an investment, ongoing monitoring of the investment, and financial reporting.

The documentation compiled should support the existence of:

- A formal policy and procedures for approving valuations;
- A process to obtain timely information from the underlying fund, including information about the fund's underlying investments;
- Valuation consistency year over year and across investments using the same methodology and metrics; and
- A formal review of the financial statements, including audited financial statements.

While the Practice Aid does not set requirements, Appendix Two does provide specific examples of the internal control procedures. Amanda Nelson, a partner in KPMG's Department of Professional Practice and chair of the AICPA Alternative Investment Task Force, emphasized that it is important not to shortchange the financial reporting controls. Auditors will be asking a lot of questions about the availability of financial reporting from the fund companies, and it is management's responsibility to understand its funds' underlying investments and internal controls.

STRATEGIES FOR IMPROVING THE AUDIT EXPERIENCE

Strother Asquith, director of investment administration for St. Jude Children's Research Hospital, provided valuable insight from the client perspective. St. Jude maintains a very diversified portfolio with a material alternative investment mandate, which made it necessary that they be diligent and thorough in preparing for the audit. He noted that, because of the additional resources needed to prepare the documentation before and during the audit as a result of the Practice Aid, clients may experience additional audit-related costs, as well as increased expenses from the audit firm due to the complexities of auditing these types of holdings.

Mr. Asquith explained, "[Attorney] Johnnie Cochran once said in a television commercial he impressed upon his firm's associates the importance of 'preparation, preparation, preparation …' Our mantra in preparing for our audit … was 'documentation, documentation, documentation.' We were unsure how the audit team would approach the new AICPA requirements, so we invested significant time documenting the initial due diligence, ongoing monitoring and financial reporting controls listed in the Practice Aid's Appendix 2. Most of these controls were already in place, but we had not committed them to writing. We prepared by using Appendix 2 from the Practice Aid as our bible."

CONTINUED

“Audit preparation should begin prior to the actual investment. There needs to be clear communication between the fund and the investor. Make sure that the fund understands what you, the investor, need regarding documentation and valuation and the timing requirements.”

John Stomper, partner – Audit and Enterprise Risk Services, Deloitte and Touche LLP

He offered the following best practices St. Jude’s Hospital has implemented in response to the Practice Aid:

- Document procedures for evaluating an investment, monitoring and reporting. Provide documentation on transaction controls (Statement on Auditing Standards 70). Compile all investment committee meeting minutes and biographies of investment committee members.
- Establish a group of qualified people from a variety of disciplines (human resources, accounting/finance, treasury, investment management, etc.) to consult throughout the audit process. Coordination between the investment and accounting teams is critical.
- Create a comprehensive investment holdings matrix that documents information about all the fund investments, including valuations. Post information from multiple sources, including fund manager statements, audited financial statements and K-1s. This was the first document requested by the team auditing St. Jude.
- Track all fund company contacts made during the year, including meetings and conferences attended, follow-ups performed, conference calls, etc.
- Compile roll-forwards for the funds. Reconcile the fund performance from the beginning to the end of the time period. For nonmarketable funds, complete a three-way reconciliation of capital calls and distributions between the records of the investor, the custodian and the fund. Include index benchmarks and peer fund performance measures to demonstrate how your funds tracked, and provide explanations for exceptionally good or bad returns. Ask your consultant to provide peer group returns using the consultant’s larger universe of funds. The roll-forwards were one of the most helpful tools for St. Jude’s auditors. They particularly liked the roll-forwards broken down by month to enable them to pinpoint significant transactions and valuation changes.

After completing these extensive preparations for the audit, St. Jude realized the ongoing tracking and documentation of all contacts and activities related to their alternative investments can be a huge undertaking. They are investigating using a sales management database tool to assist them in maintaining and reporting this information. They are also making some changes to their regular monthly recordkeeping process to ensure adequate information will be gathered going forward. These changes include:

- Substantially revising the monthly investment summary spreadsheet so that it not only provides information for the accounting department to post to the general ledger, but also fulfills the new function of providing numbers in a format that can be easily cut and pasted to build roll-forward schedules.
- Develop schedules to track sales, cost of sales and purchases from multiple custodian bank sources monthly to prevent potential unexplained differences between the custodian reports reviewed by the auditors and the financial statements at fiscal year-end.
- Develop a rotating schedule for performing the three-way reconciliation of all nonmarketable funds.

THE CUSTODIAN'S ROLE

Institutional investors often turn to their custodian for assistance in responding to auditors' requests. However, there has been a shift away from reliance on custodial statements as the definitive source of values for certain hard-to-value assets. Custodial statements reflect a pass-through of prices provided by a third party. When an independent price or exchange price is not available for an investment, the custodian may obtain the pass-through price from the general partner or fund manager. The custodian cannot make any representation that these third-party pass-through prices reflect fair value.

This is because custodians are not entitled to and may not normally receive information that would be germane to assessing fair value. For instance, the custodian may not receive audited financial statements, fund objectives or other proprietary information that would help an investor determine what the valuation (or investment) risks might be.

The custodian settles the transactions, reflects them on the trust statement and passes through the valuation information compiled by the fund company and provided to Northern Trust. Due to the inherent limitations of the custodial role, it would be inappropriate for a custodian to render an assessment as to whether an alternative asset price received from the manager is a fair price. Performance and investment program consulting services provided by custodial banks are better suited to provide support for reviewing valuation assertions, but these services are usually an adjunct to the custody reporting that serves as the basis for the financial statements.

THE EFFECT OF THE NEW AUDIT GUIDELINES

One of the most significant changes to come from the new audit guidelines has been the increased participation of investment teams in the audit process. Plan administrators who face the largest audit hurdles are those who view the investment oversight process as completely separate from the financial statement preparation process.

Those who have fully embraced "management's responsibilities" as outlined in the AICPA Practice Aid have implemented such formal steps as scheduling periodic or annual valuation risk assessment meetings between the investment side of the house and the financial accounting departments. The financial accounting staff members rely on the custodial reports to help cull the marketable from the nonmarketable securities in preparation for their meetings with the investment teams. Custodial reports that provide detailed information about the age, source and type of a specific asset price, or the statement receipt date and roll-forward values for limited partnerships are popular tools in helping both teams focus their valuation review on those hard-to-value assets and understand how the custodial prices are derived. Reports targeted specifically for financial reporting preparation, including those designed to assist with Financial Accounting Standard 157 fair valuation disclosures, are under development.

WORKING TOGETHER, WORKING SMARTER

Above all, continued dialogue among the various players – from those who prepare the financial statements to the auditors to the investment committees to the fund companies – will be essential as we continue to address the practical implications of the Practice Aid.

"Working together, we can hopefully continue to improve the process by establishing and communicating best practices so that we can all work smarter, not harder, as we focus on making the process more efficient and effective for all parties."

Debbie Smith, National Partner – Employee Benefit Plan Assurance, Grant Thornton LLP

CONTINUED

ADDITIONAL RESOURCES

www.aicpa.org
Alternative Investments Audit Considerations: A Practice Aid for Auditors

www.peigg.org
Private Equity Industry Guidelines Group

www.grantthornton.com
Grant Thornton LLP

www.kpmg.com
KPMG International

www.deloitte.com
Deloitte

www.nacubo.org
National Association of College University Business Officers

www.fasb.org
Statement of Financial Accounting Standards No. 157 Fair Value Measurements

CONTINUED

The views, opinions and investment information expressed are those of the individuals noted herein, do not necessarily represent the views of Northern Trust or any other person in the Northern Trust organization and are subject to change based on market or other conditions. The material is provided for informational purposes only and should not be construed as investment, tax or legal advice. Northern Trust disclaims any responsibility to update such views. Northern Trust does not guarantee that the information supplied is accurate, complete or timely and does not make any warranties with regard to the results obtained from its use.

Northern Trust

Q20597 (1/08)