

AICPA Not-For-Profit Conference
June 15-16, 2006

Valuation of Alternative Investments

Presented by:

John Kroll – The University of Chicago

John Mattie – PricewaterhouseCoopers

Valuation of Alternative Investments

What has happened since last August ???

A lot !!!

Auditing Interpretations

- First some background....
- What are Auditing Interpretations?
 - Recommendations on the application of SASs in specific circumstances
 - Issued under the authority of the ASB
 - Q&A format
 - If the auditor does not apply the auditing guidance included in an Interpretation, the auditor must explain how he or she complied with the SAS guidance.

Auditing Interpretation - AU 328

- Auditing Interpretation – AU 328:
 - Deals with **Auditing Interests in Trusts Held by a Third-Party Trustee and Reported at Fair Value.**
 - Issued in August 2005 and was immediately applicable.
- The Interpretation to AU 328 answers the following question:
 - “In circumstances in which the auditor determines that the nature and extent of auditing procedures should include verifying the existence and testing the measurement of investments held by a trust, does receiving a confirmation from the trustee, either in aggregate or on an investment-by-investment basis, constitute adequate audit evidence with respect to the existence assertion and auditing fair value measurements in accordance with Section 328, *Auditing Fair Value Measurements and Disclosures*?”

Auditing Interpretation - AU 332

- Auditing Interpretation – AU 332:
 - Deals with **Auditing Investments in Securities Where a Readily Determinable Fair Value Does Not Exist.**
 - Issued in August 2005 and was immediately applicable.
- The Interpretation to AU 332 answers the following:
 - “In circumstances in which the auditor determines that the nature and extent of auditing procedures should include verifying the existence and testing the measurement of investments in securities, does receiving a confirmation from a third party, either in aggregate or on security-by-security basis, constitute adequate audit evidence with respect to the existence and valuation assertions in SAS No. 92?”

Valuation of Alternative Investments

- **The Crux of AU 328:**
 - Simply receiving a confirmation from the trustee, either in aggregate or on an investment-by-investment basis, does not in and of itself constitute adequate audit evidence with respect to the valuation assertion.
- **The Crux of AU 332:**
 - Simply receiving a confirmation from a third party, either in aggregate or on a security-by-security basis, does not in and of itself constitute adequate audit evidence with respect to the valuation assertion. In addition, receiving confirmation from a third party for investment in aggregate does not constitute adequate audit evidence with respect to the existence assertion.
- **Both interpretations go on to say that receiving confirmation on a security-by-security basis typically would constitute adequate audit evidence...HOWEVER, specific audit guidance is not provided.**

Valuation of Alternative Investments

- **The Auditing Interpretations remind readers of management's responsibility**
 - Management is responsible for making the fair value measurements and disclosures included in the financial statements. As part of fulfilling this responsibility, management needs to establish an accounting and financial reporting process for determining the fair value measurements and disclosures, select appropriate valuation measurements, identify and adequately support any significant assumptions used, prepare the valuation, and ensure that the presentation and disclosure of fair value measurements are in accordance with GAAP.

Valuation of Alternative Investments

Now for the kicker...the Interpretations state:

- If unable to audit the existence and/or the valuation of the investments as of the balance sheet date, the auditor should consider a scope limitation to either...
 - Qualify the opinion, or
 - Disclaim an opinion

Scope Limitations...a reminder

- *The auditor can determine that he or she is able to express an unqualified opinion only if the audit has been conducted in accordance with generally accepted auditing standards and if he or she has therefore been able to apply all of the procedures considered necessary in the circumstances. Restrictions on the scope of the audit, whether imposed by the client or by circumstances, such as the timing of his or her work, the inability to obtain sufficient competent evidential matter, or an inadequacy in the accounting records, may require the auditor to qualify his or her opinion or disclaim an opinion. In such instances, the reasons for the auditor's qualification of opinion or disclaimer of opinion should be described in the report. [AU 508.21]*

Valuation of Alternative Investments

So now what do we do ? Is help is on the way ?

- The Interpretations do not provide any additional guidance with respect to auditing the valuation assertion
- No intention of revising the Interpretations
- Hopefully work of the AICPA Task Force will provide guidance

So What Really Happened in Fiscal 2005 ?

- To the best of our knowledge and belief, in fiscal 2005 no college or university received a scope limitation opinion related to the valuation of alternative investments.
- Conclusion...auditors and their clients found another way to get comfortable with both existence and valuation.

Disclosure Examples from Three Institutions

Investments and Investment Income

Investments are stated at fair value. The fair value of all debt and equity securities with a readily determinable fair value are based on quotations obtained from national securities exchanges. The alternative investments, which are not readily marketable, are carried at estimated fair values as provided by the investment managers. The university reviews and evaluates the values provided by the investment managers and agrees with the valuation methods and assumptions used in determining the fair value of the alternative investments. Those estimated fair values may differ significantly from the values that would have been used had a ready market for these securities existed.

Disclosure Examples from Three Institutions

Alternative investments are less liquid than the University's other investments. The following table summarizes these investments strategy type at June 30, 2005 and 2004.

| <u>Alternative investment strategy</u> | <u>2005</u> | | <u>2004</u> | |
|--|------------------------|---------------------|------------------------|-------------------|
| | <u>Number of Funds</u> | <u>Fair Value</u> | <u>Number of Funds</u> | <u>Fair Value</u> |
| Multistrategy, fund of funds, and absolute return | 29 | \$ 563,897 | 31 | 545,825 |
| Event driven and distressed securities | 15 | 161,580 | 11 | 100,015 |
| Relative value | 2 | 24,770 | 2 | 35,906 |
| Real estate | 3 | 16,058 | 3 | 9,155 |
| Long-short equity | 11 | 187,770 | 6 | 77,934 |
| Fixed income arbitrage and aggressive fixed income | 7 | 164,726 | 5 | 122,437 |
| | <u>67</u> | <u>\$ 1,118,801</u> | <u>58</u> | <u>\$ 891,272</u> |

Alternative investments include limited partnerships, limited liability corporations, and off-shore investments funds. Included in investments of the limited partnerships are certain types of financial instruments, including, among others, futures and forward contracts, options, and securities sold not yet purchased, intended to hedge against changes in the market value of investments. These financial instruments, which involve varying degrees of off-balance-sheet risk, may result in loss due to changes in the market (market risk).

Disclosure Examples from Three Institutions

The Institute's interests in limited partnerships and offshore funds represent 18% and 68%, respectively, 86% collectively of total investments held by the Institute at June 30, 2005. These instruments may contain elements of both credit and market risk. Such risks include, but are not limited to, limited liquidity, absence of oversight, dependence upon key individuals, emphasis on speculative investments (both derivatives and non-marketable investments), and nondisclosure of portfolio composition.

Investments are stated at fair value and are recorded on the trade or contract date. The estimated fair value of investments is based on quoted market prices, except for alternative investments for which quoted market prices are not available. The estimated fair value of certain alternative investments such as private equity interests, is based on valuations provided by the external investment managers as of March 31, adjusted for cash receipts, cash disbursements and securities distributions through June 30. The University believes the carrying amount of these financial instruments is a reasonable estimate of fair value. Because alternative investments are not readily marketable, their estimated value is subject to uncertainty and therefore may differ from the value that would have been used had a ready market for such investments existed. Such difference could be material.

Sample Best Practices for NFP's

The following series of slides provide some guidance regarding:

- Pre-investment and Post-investment monitoring procedures
- Guidance is assessing the reasonableness of fair values provided by the investment managers
- Some thoughts on audit procedures

Sample Best Practices for NFP's...

Pre and Post Investment Monitoring Procedures

The institution should consider the following procedures before it even thinks about investing in alternative investments:

- Hold a face to face meeting with the management team
- Conduct on-site visit(s)
- Evaluate investment strategy, process, portfolio, and historical track record
- Document review by investment office staff, including offering memorandums, legal agreements, and financial statements
- Evaluate how specific allocation fits within the asset class portfolio
- Solicit information regarding the General Partner team from third parties
- Do reference checks
- Do third party background checks on senior professionals
- Review and negotiate legal agreements...consider using outside counsel
- Complete a formal investment memo/write-up for approval

Sample Best Practices for NFP's...

Pre and Post Investment Monitoring Procedures

The institution should consider the following on-going monitoring procedures after investing in alternative investments:

- Conduct regular in person or telephonic meetings with the GP
- Conduct on-site visits
- Review fund communications including financial statements and shareholder communications
- Review valuation of portfolio valuations for reasonableness
- Monitor portfolio performance:
 - Compare performance to benchmark returns
 - Review portfolio holdings on a regular basis
 - If the investment strategy changes in mid-stream...check it out
- Monitor firm/manager:
 - Review press reports for significant management changes
 - Monitor staffing levels
 - Monitor size of assets under management for consistency with business plan

Sample Best Practices for NFP's...

Assessing Fair Values

The institution and/or its auditors should consider the following procedures (not intended to be all inclusive) in assessing the reasonableness of fair values provided by investment managers:

- Document policies with respect to alternative investments including due diligence in manager/fund selection (fund administration, including accounting, controls, and valuation methodology should be areas of inquiry in due diligence).
- Obtain an understanding of the fund's strategies and holdings, ascertaining the nature of the underlying investments (i.e. marketable securities, derivatives, private companies, real estate, etc).

Sample Best Practices for NFP's...

Assessing Fair Values

- The Institution should consider requesting the detail of the portfolio (underlying securities). Obtaining this information will enable a more robust analysis supporting the institution's conclusion regarding the reasonableness of fair value.
- Obtain the fund's audited financial statements noting (a) whether the independent auditor's opinion is unqualified on a GAAP basis or modified; (b) the audit firm (ascertain credentials, if you are unfamiliar with the audit firm); (c) disclosed valuation methodologies; (d) other disclosures which may impact on valuation or the institution's own disclosures; (e) date of independent auditor's report; and (f) subsequent events footnote, if any.

Sample Best Practices for NFP's...

Assessing Fair Values

- Obtain previously reported value of the institution's investments as of the fund's fiscal year-end and compare such to the value based upon the audited financial statements. For example, obtain December 31st unaudited value as previously reported and compare to calculated value using percentage ownership at that date (perhaps from K-1) and equity per audited financial statements....hopefully the #'s are close which would be an indication the manger's estimates are reasonable.

Sample Best Practices for NFP's...

Assessing Fair Values

- Compare value at fund's year-end (most likely December 31) to value at institution's year-end and assess reasonableness of the change considering appreciation/depreciation, additions, distributions, and other changes. Consider reference to external hedge fund indices (e.g. S&P Hedge Fund Index) to support assessments of returns during the period.
- Auditors should confirm with/request from the fund manager, as of the balance sheet date, the following information: (a) fair value; (b) basis of such fair value, including whether such valuation is consistent with the methodology applied at the fund's year-end (this may be particularly important for institutions with May or August year-ends); (c) ownership interest; and (d) SAS 70, from fund administrator if available.

Task Force Draft Confirmation Example

Please provide the following information...

- Capital balance activity...BOY balance, contributions, withdrawals, management fees charged, incentive allocation fees, EOY balance
- Valuation date for capital account balance
- Class of shares and units held
- Ownership interest as a % of fund net assets
- Date of most recent partnership agreement
- Date of any side letter agreements
- **A detail list of the investment holdings as of the NFP's fiscal year end**
- Basis of accounting used

Audit Procedures... Things to Consider

- How do we audit these things?
- SAS 101 requires the auditor:
 - Obtain evidence regarding GAAP
 - Understand the entity's processes and controls
 - Understand management's significant assumptions
 - Evaluate management's ability and intent
 - Evaluate the appropriateness of the method
 - Consider the use of a specialist
 - Test fair value measurements and disclosures
 - Communicate sensitive fair value estimates to the audit committee

Audit Procedures...Things to Consider

- Understand management's process and what they do
- Management has to understand enough to take responsibility for the number on the financial statements
- Management cannot simply outsource this responsibility...if outsourced, on-going monitoring of the process is a must
- Risk assessment:
 - The auditor gains an understanding of the inherent risk in the portfolio
 - The higher the risk, the more persuasive the audit evidence is needed

Audit Procedures...Things to Consider

- **No detailed confirmation does not necessarily mean a scope limitation**
- If auditor determines that confirmation is necessary, then Interpretations provide guidance
- **The auditor considers all of the information obtained and then determines auditing procedures and reasonableness of the FMV of the alternative investments**

Some Practical Questions from an NFP's Perspective

- Will the GP provide the requested information, especially the details of the under-lyings, on a timely basis ?
- Fiscal year-end alternative investment values are generally not received until at least 60 days after the quarter closes, sometimes as late as 90 days. What impact does this have on the timely completion of fiscal year end audits ?
- So the auditor gets confirmation of the underlying investments and their values...what is the auditor going to do with the information ?
- Assuming a June 30 fiscal year end...Does the difference between a June 30 value and a March 31 roll-forward value constitute an un-booked adjustment ?

What Others Have to Say...

In January 2006, Cambridge Associates wrote clients on this topic.

- “We do not independently verify their [fund managers] valuations, nor do we have the capacity to examine other back office functions such as best execution.”
- “The audit standards are new to the investment community, vague, and would appear to require auditors to obtain information, particularly on valuations, that is not readily available to our clients or to Cambridge. As they attempt to adhere to these standards, we expect that the major auditing firms will start to provide better guidance to their clients.”

What Others Have to Say...

In March 2006, Moody's issued a Special Comment, *Changes in Audit Guidelines for Alternative Investments held by Higher Education and Not-for-Profits Highlight Risks of These Strategies.*

- “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 on order to assess the fair value of the investment. If the not-for-profit organization'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.”
- “The increased level of scrutiny by auditors highlights the significant expertise, cost and time associated with diligent monitoring of these investments.”
- “Universities and other non-profit without sufficient resources to invest in appropriate investment monitoring remain our greatest concern.”

Alternative Investments Task Force

- Objective- To consider accounting and auditing issues with respect to alternative investments
- Held meetings on February 17, March 13, and April 20, 2006

Alternative Investments Task Force

- Composition:
 - 2 representatives from AICPA Not-for-Profit Expert Panel
 - 3 representatives from AICPA Healthcare Expert Panel
 - 2 representatives from AICPA Investment Companies Expert Panel
 - 1 representative from AICPA Employee Benefits Expert Panel
 - 2 representatives from colleges and universities
 - 1 fund manager

May the **TASK FORCE**
be with us as we enter
into our fiscal year end
audits