

Institutional oversight*

Managing the challenges of alternative investments
in the higher education environment



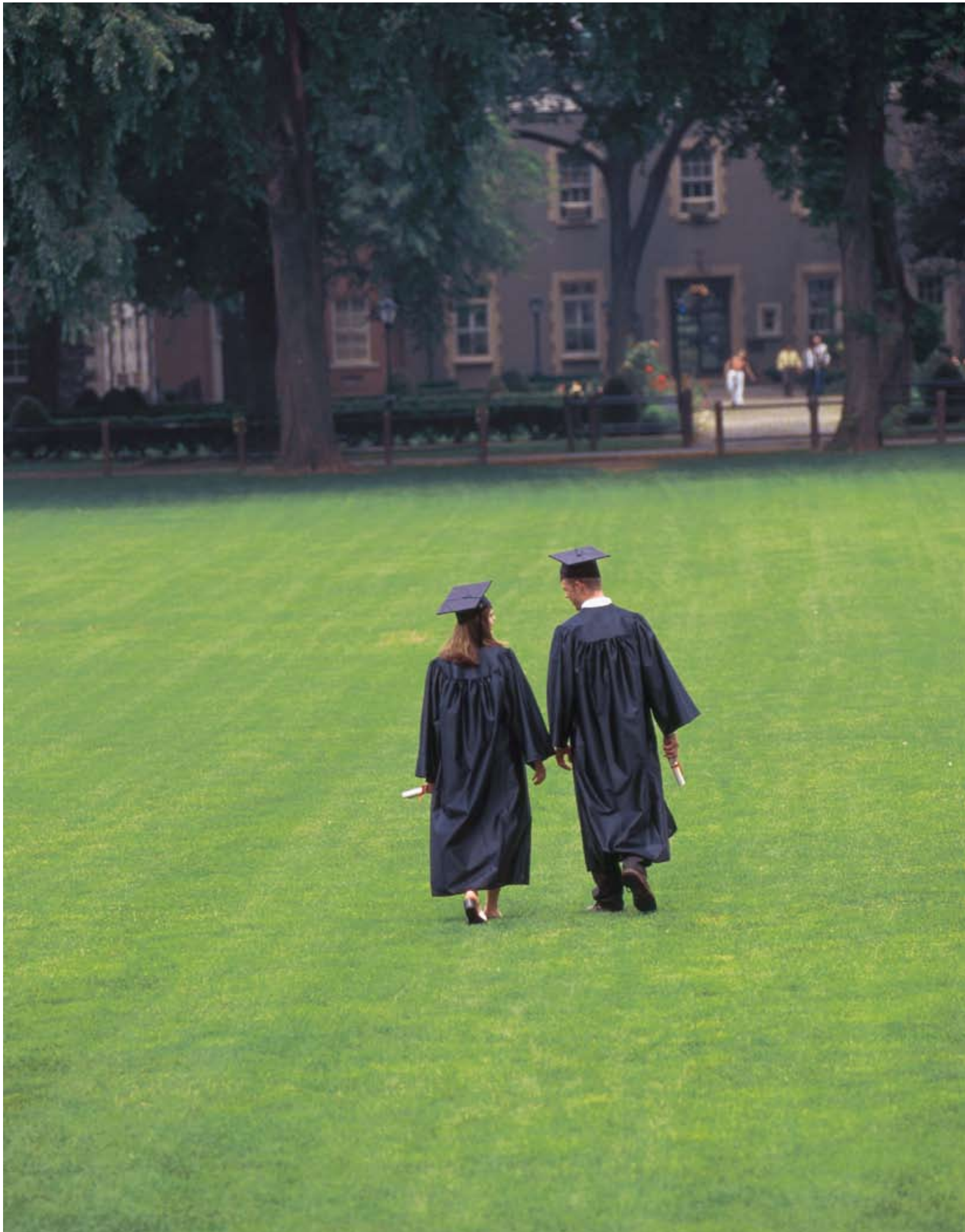
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Colleges and universities as well as other endowed institutions are investing an increasing percentage of their endowments in alternative investments. So far, the returns have been worth the risk for most institutions. Those with alternative investments in their portfolios have enjoyed considerably higher yields, and potentially lower volatility than those without. The downside continues to be their potential valuation risk, and the need to provide evidence of existence in support of valuation, which requires vigilant management and oversight by well-informed investors.

In 2004, PricewaterhouseCoopers published a white paper, *Meeting the Challenges of Alternative Investments*,¹ in which we discussed four key issues: the selection, monitoring, valuation and reporting of alternative investments. Today, after the American Institute of Certified Public Accountants (AICPA) issued two auditing interpretations in 2005 and a practice aid in 2006, the guidance in our 2004 white paper is still applicable—but we now have additional perspective. The objective of this 2007 PricewaterhouseCoopers paper is to refine and add to our 2004 paper based on the AICPA's interpretative guidance and evolving practices by highly endowed institutions investing in alternative investments.

This paper is designed to highlight and summarize for officers, senior management, and board members of colleges, universities and other highly endowed institutions:

- Key issues associated with alternative investments, which continue to be their selection, monitoring, valuation and reporting
- Internal controls and leading practices that colleges and universities should consider implementing, if they have not already done so
- Practical suggestions for improving an institution's documentation of their internal controls
- Resource considerations in managing the risk of alternative investments

Note that this paper is not intended to determine asset allocation decisions. It is meant to inform readers of the inherent audit risk in this asset category and provide suggested but not all-inclusive practices for managing such risk.

Introduction

Definitions

In July 2006, the AICPA issued *Alternative Investments—Audit Considerations: A Practice Aid for Auditors* (the “Practice Aid”) that defines alternative investments as: “private investment funds meeting the definition of an investment company under the provisions of the AICPA Audit and Accounting Guide, *Investment Companies*, such as hedge funds, private equity funds, real estate funds, venture capital funds, commodity funds, offshore fund vehicles, and funds-of-funds, as well as bank common/collective trust funds.”²

The underlying investments of such funds may include marketable and nonmarketable securities as well as derivatives and other illiquid investments.

A “fund-of-funds” is a pooled investment fund that invests in underlying funds. For example, a fund-of-funds could invest in third-party hedge funds or private equity funds, or in some cases, a combination of both. A potential advantage of a fund-of-funds is the opportunity to increase diversification. On the other hand, management fees and other expenses can be higher since an investor is paying an additional layer of fees at the fund-of-funds level.

Alternative investments may be structured as limited partnerships, limited liability corporations, trusts or corporations. In this paper, we refer to alternative investments either as “funds” or “limited partnerships.” Alternative investments are often managed by a “general partner” or a “fund manager,” and we use both terms in this paper.

Hedge funds are generally less liquid than traditional investments. Liquidity terms are stated in the fund’s governing documents, which include its limited partnership agreements, offering memorandum and/or articles of association. Among others, liquidity terms include “lock-up periods”³ and “gates”⁴ that reduce the liquidity of hedge funds and therefore, potentially make them more difficult to value. The ability of a hedge fund manager to utilize so-called “side pocket accounts” may also complicate the determination of fair value.

With respect to private equity funds, institutions generally commit a specified amount of capital to the fund upon its inception, and may be required to commit additional capital at future points. The general partner draws down the capital to invest generally in the equity or debt securities of private companies. By the terms of their governing documents, private equity funds often have limited

lives of eight to ten years, for example, although the general partner may extend their life for a specified time period (e.g., two years). Such funds present few opportunities, if any, for institutions to withdraw prior to the fund’s termination. Rather, the institution receives distributions from the fund only when the fund’s investments are realized, at which time the proceeds are distributed to the fund’s general and limited partners pursuant to prescribed terms under the fund’s governing documents.

Investment allocation and returns

Over the past ten years, alternative investments have assumed a larger share of the investment portfolios of colleges and universities. How great a share? Several surveys track endowment allocation and performance. One annual study is conducted by the National Association of College and University Business Officers (NACUBO) in conjunction with TIAA-CREF, a national financial services organization, and is known as the “NACUBO Endowment Study.” Presented in Chart 1 is the average investment allocation for all survey participants as well as the investment allocation for survey participants with investment pools greater than \$1 billion.

The first two bars in Chart 1 show the allocation of investment pools to alternative investments. Institutions with investment pools over \$1 billion invest 36.5 percent in alternative investments, while the average allocation of all the participating institutions to alternative investments was 15.3 percent.⁵

In what types of alternative investments are institutions investing? Chart 2, which also is based on the 2007 NACUBO Endowment Study, presents the allocation of investment pools among alternative investment categories, including hedge funds, private equity, venture capital, natural resources and other.

As you can see from Chart 2, more is invested in hedge funds than in any other category of alternative investments. Private equity funds are second.

The investments that endowed institutions are making in alternative products have caught the eye of the Securities and Exchange Commission (SEC), which oversees the financial markets in the U.S. The SEC's Chairman, Christopher Cox, commented about institutions that have invested in hedge funds:

Chart 1: Investments of most heavily endowed and average institutions

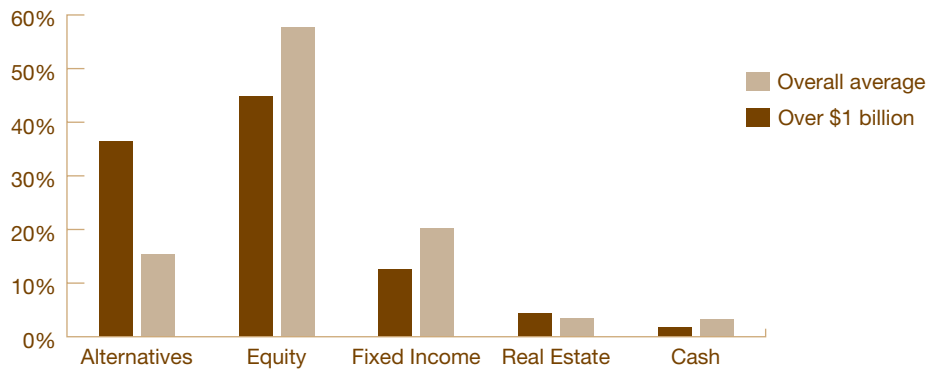


Chart 2: Allocation of investment pools among alternative investment categories

	Hedge Fund	Private Equity	Venture Capital	Natural Resources	Other Products	Total Alternatives
Average Institution	9.6%	1.9%	0.9%	1.5%	1.4%	15.3%
Institutions with > \$1 billion	22.4%	5.9%	3.5%	4.2%	0.5%	36.5%

“...the SEC’s best estimate is that there are now approximately 8,800 hedge funds, with approximately \$1.2 trillion of assets. If this estimate is accurate, it implies a remarkable growth in hedge fund assets of almost 3,000% in the last 16 years. Much of this growth is attributable to increased investment by institutions. This includes not only investment companies and investment banks, but also private and public pension plans, endowments, and foundations.”⁶

We saw in Chart 1 that institutions with the largest endowments tend to have the highest concentrations of alternative investments (36.5 percent for the largest compared to 15.3 percent for all institutions). They also tend to have the highest returns, and much of the credit goes to alternative investments. According to the most recent *NACUBO Endowment Study*, the one-year rate of return for institutions with investment pools of greater than \$1 billion was 15.2 percent for the fiscal year ended June 30, 2006, as compared to an overall average return of 10.7 percent.⁷

Average fiscal 2006 returns for alternative strategies are presented in Chart 3 (see next page), which relies on data from a recent Commonfund survey.⁸ Such returns make a compelling case for investing in alternative products.

The average overall one-year return for alternative investments was 14.6 percent. In contrast, the one-year return for the Standard & Poor's 500 was 8.6 percent; the Russell 3000 Index was 9.6 percent; the Lehman Brothers Aggregate Bond Index was -.8%; and the Consumer Price Index for All Urban Consumers was 4.3%.⁹

Risk

As with any investment with increased reward comes increased risk. Moody's Investors Services notes, "Unlike traditional publicly traded equity and fixed income holdings, many of these alternative assets may have lock-up provisions that limit an organization's ability

to sell them if liquidity is needed and are less transparent in their methodologies/strategies. With less to invest, some institutions may not have access to the top-performing funds."¹⁰

Among others, alternative investments may carry liquidity risk (i.e., they cannot be easily liquidated since there is no ready market), concentration risk (i.e., the investments may be concentrated in a particular industry, geography, asset class, or fund, while diversification in each of these areas is usually considered to reduce risk), and valuation-related risk (i.e., readily observable market sources are not available for such investments and/or standard valuation methodologies are not utilized, making their valuation inherently more imprecise). In addition, for various reasons, alternative investments may be difficult for the average investor to understand, which also heightens the risk given the complexity associated with their investment strategies and the manner in which they are executed.

AICPA guidance

The audits of alternative investments of colleges and universities have been challenging for institutions and auditors over the past two years as a result of new audit guidance. In August 2005, the AICPA, which sets professional standards for independent auditors, issued two auditing Interpretations (the "*Interpretations*") that refined the evidence and documentation requirements to support the "valuation" and "existence" of alternative investments.¹¹ Then, nearly a year later, the AICPA issued its *Practice Aid*, in an attempt to clarify its earlier Interpretations.¹²

With respect to existence, the question is: Do the institution's alternative investments exist at the financial statement date, and have the related transactions occurred during that period? While confirming the existence of assets that are held by third parties provides some audit evidence, the AICPA's *Interpretations* and *Practice Aid* say that, by itself, a confirmation in the aggregate does not constitute adequate audit evidence. Based on the guidance in the *Practice Aid*, additional audit evidence could be obtained by performing such procedures as reviewing executed partnership or other agreements, reviewing fund statements as well as annual audited financial statements, and vouching cash receipts and disbursements.

With respect to valuation, the question is: Are the alternative investments stated in the institution's financial statements at their fair value? Confirming the value of the alternative investments from third-party fund managers provides one piece of evidence.¹³ Based on the guidance in the *Practice Aid*, additional audit evidence could be obtained by reviewing the detail of the underlying investments, evaluating the fund's valuation procedures, and reviewing the fund's audited financial statements as well as its periodic (e.g., quarterly) unaudited financial data.

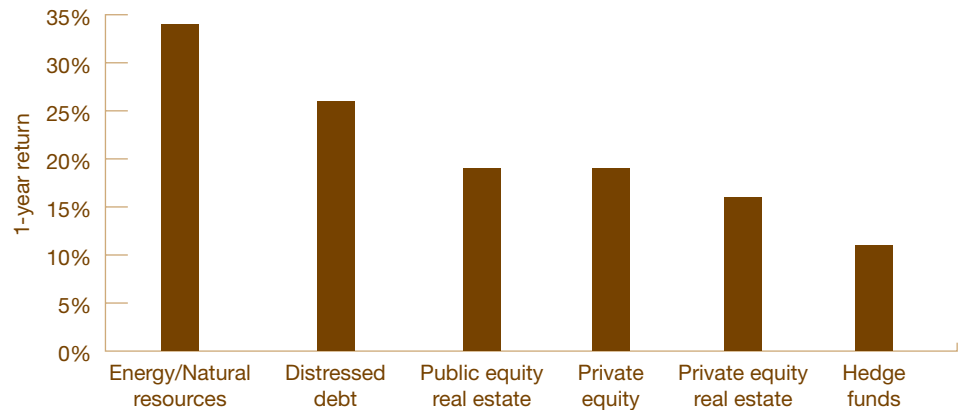
Effect of AICPA's guidance on institutions

Because of the timing of the AICPA's guidance, institutions were concerned that their financial statements would be issued late, or worse, with a qualified audit report, which would set into motion several undesired outcomes. But despite the difficulties of auditing alternative investments, most institutions received "unqualified" opinions on their FY'06 financial statements,¹⁴ although some were not issued on time.

How do we know? In December 2006, NACUBO hosted an alternative investments webcast for its members. Approximately 185 institutions participated in a discussion led by NACUBO, PricewaterhouseCoopers and representatives from several endowment institutions. At various points, they were asked to respond to polling questions. We believe their answers to be directionally accurate, if not statistically valid.

When asked if the issuance of their FY'06 financial statements had been delayed because of the alternative investments issue, 40 percent of the respondents said yes, while the remaining 60 percent said no. When asked about the external auditor's report, 94 percent said it was unqualified. For another 6 percent of the institutions, the auditor's report included an "emphasis of a matter"¹⁵ but was otherwise unqualified. None of the respondents had a scope limitation.

Chart 3: Return by alternative investment category



Alternative investments practices

The remaining sections of this paper will deal with how institutions can enhance their procedures and controls over alternative investments and meet the requirements of the audit guidance issued over the past couple of years. We also will help answer the question: What can institutions do to make their fiscal year 2007 audits go more smoothly than their fiscal 2006 and 2005 audits?

Leading practices begin with preinvestment due diligence. Due diligence refers to the process of research and analysis that should take place before the investment is made.

Preinvestment due diligence

Adequate due diligence before making an investment is crucial. Investors need to thoroughly review and understand a fund manager's capabilities, organization, goals, strategies and controls. They should consider establishing a formal selection process, perhaps with a pre-investment checklist.

Some institutions rely on third parties to perform preinvestment due diligence. The institution is still ultimately responsible for performing sufficient due diligence, making an informed choice, and documenting the selection process. The institution can delegate, but it should seek evidence that the third party performed the due diligence.

We recommend that institutions consider the preinvestment practices that are summarized in Chart 4. Preinvestment

Chart 4: Recommended preinvestment due diligence practices¹⁶

Assess the personnel

- Meet (preferably face-to-face meetings) with the fund manager and the team to evaluate their qualifications, experience and skills. The integrity of the team is crucial given the risk of alternative investments and the lack of transparency into the detailed holdings.
- Consider any past experiences the institution might have had with the fund manager or team members.
- Make inquiries about the fund manager to other institutions, contacts in the investment community, members of the institution's investment committee, service providers, and consultants.
- Request references from key team members and check them with firms and clients. Perform background checks and verify biographical information.
- Search for information about NASD-registered firms and their registered "brokers" (e.g., conduct, license status) at www.nasdbrokercheck.com.¹⁷ Search for information (e.g., on Form ADV) about "investment advisers" (e.g., disciplinary events) at www.adviserinfo.sec.gov.¹⁸

Evaluate and document the investment strategy and risk

- Evaluate and document the fund's investment strategies, processes, and the nature of its underlying investments, and applicable benchmarks.
- Evaluate and document how an allocation to the fund fits within the institution's overall portfolio, and consider whether the fund's liquidity terms are a good match for the institution.
- Review the fund's most current financial statements (audited, if possible) to corroborate information that the fund has provided with respect to its net assets and investment portfolio, as well as to identify other potential issues associated with the financial statements, including the basis of accounting utilized, the fund's year-end, any unusual accounting policies and the reputation of the auditor.
- Review and analyze the fund's assets under management and its historical performance track record.
- Develop an initial risk assessment profile to gauge the relative risk of investing in the fund. Outline the parameters of acceptable risk and what steps must be taken if the parameters are exceeded. Weigh the risk of an investment against the institution's stated investment objectives.
- Inquire as to the registration status of the fund manager and request the fund's written compliance program. (All funds that are registered under the Investment Advisers Act of 1940 should have this.)
- Request and review other documents, including, for example, offering memorandum, legal agreements, pitch books, and Form ADV, which contains information about key personnel as well as about a fund manager's business operations.¹⁹
- Consider the potential impact of federal and state unrelated business income taxes on the fund's projected results.

practices should include an assessment of the people involved, strategy and risk, and operational issues, as well as how an institution will review and document its approval process.

Many hedge fund managers are “investment advisers” under the Investment Advisers Act of 1940. This Act gives the SEC authority to enforce fund managers’ fiduciary obligations. The SEC has brought several enforcement cases against hedge funds for such matters as misrepresenting portfolio performance, misleading disclosure regarding claimed trading strategies, and improper valuation of assets.²⁰ In PricewaterhouseCoopers’ 2004 edition of *Meeting the Challenges of Alternative Investments*, we suggested practices that were designed to protect institutions from market abuses. They are prudent practices to follow that are worth repeating:

- Invest in funds with long, successful track records through multiple business cycles
- Understand the underlying trading premise of the fund and risk management controls
- Be mindful of manager turnover and its consequences
- Inquire about the findings of regulators when they do inspections
- Understand the quality of the fund’s infrastructure—is it too lean?
- Look for funds with established minimum assets under management

Chart 4: Recommended preinvestment due diligence practices

continued

Consider operational issues

- Consider the federal, state and foreign tax reporting and compliance issues that will need to be managed if the institution invests in a particular fund.
- Anticipate the control, monitoring, valuation, and reporting challenges that will arise if the institution decides to invest.
- If the institution plans to utilize an outside service provider with respect to the identification, assessment and/or monitoring of any investment activities, consider the related challenges (e.g., security, controls, systems compatibility).
- Understand the policies and procedures used by the fund manager to value the underlying investments, including the valuation methodologies, sources and inputs and key assumptions, and document them.
- Evaluate the fund manager’s “back office” (i.e., the functions that perform accounting, human resources, and information systems) preferably in a face-to-face meeting. At a minimum, request and review written back office policies/procedures.
- Inquire about the existence and role of an outside service provider used by the fund manager (i.e., fund administrator). Understand whether the administrator provides independent pricing of values for the fund manager and has a SAS 70 report.
- Find out about the security of the fund’s technology environment. Ask how it tracks and restricts access to data and whether there is web-based reporting and, if so, how secure it is.
- Assess whether the fund manager has a sufficient complement of personnel with the right knowledge, experience and training necessary.
- Inquire as to how the fund managers assure themselves that the systems of internal controls over the accounting and reporting of transactions are effective and how they make sure that there is adequate segregation of duties.
- Ask the fund to provide its auditor’s assessment of internal controls, if available. Inquire about the controls that are in place for disaster recovery.

Include an approval process

- Complete a formal investment memorandum detailing the pertinent information about the fund, including investment strategy, names of key personnel, anticipated investment return, and other such details.
- Obtain approvals by the institution’s legal counsel/tax department.
- Seek the approval of the investment committee, which should be documented in the minutes. (Note that the investment committee is usually responsible for assessing the appropriateness of a particular investment.)

In summary, preinvestment due diligence involves assessing the fund manager's personnel, controls, policies and procedures. Equally important is making sure that the investment is the "right fit" for the institution in terms of its strategy and its risk profile. Keep in mind that once an institution has made an investment, its control over the fund's ongoing investment strategy or its business practices may be very limited,²¹ which is why preinvestment due diligence is so crucial. Finally, institutions should document their preselection due diligence practices.

Postinvestment monitoring

Due diligence continues after an investment is made. In general, postinvestment monitoring involves ensuring that the fund or partnership—and the institution in its role as a prudent investor—continues to have adequate controls, systems, policies and procedures in place. In addition to regular reports and telephone conversations, a common practice is an annual visit with each fund manager, during which the institution can make sure that its understanding of the fund from the preselection process is still valid. Also, the institution should prepare a memorandum documenting its conversations with the fund manager.

Some institutions may outsource ongoing monitoring activities to a third party. In this case, the institution must develop appropriate monitoring controls, and related documentation, over its third-party service provider to make sure that its monitoring activities are complete and effective.

We recommend that institutions consider following the monitoring practices that are summarized in Chart 5 (see page 11). Such actions as monitoring the fund's communications and financial reports on a regular basis are essential. The nature, timing and extent of an investor's monitoring process will depend on their risk assessment with respect to the alternative investments. Given the differences associated with varying types, structures and strategies of alternative investments, a "one size fits all" approach is not appropriate.

Tax considerations

An investment in a limited partnership by a tax-exempt organization may result in federal and state unrelated business income (UBI) tax. In addition, institutions need to consider whether their alternative investment involves a "reportable transaction," one of five types of transactions that must be reported to the IRS per Treasury regulations. Penalties for failing to report such transactions can result in substantial penalties that are not waivable. Finally, institutions should consider the possibility of reporting requirements for investments in or transfers to foreign corporations or partnerships.

Summary

Postinvestment monitoring involves continuing to be an active and informed investor. Despite the complexity of alternative investments, monitoring them requires many of the same basic procedures that institutions employ to monitor their traditional investments. However, due to the nature of these investments and the related agreements between the fund manager and institution, there are inherent challenges in obtaining reports with sufficient detail to perform extensive monitoring procedures.

Valuations

Valuation is one of the two key issues discussed in the AICPA's *Interpretations and Practice Aid*. The *Practice Aid* notes that a readily determinable fair value does not exist for many alternative investments. In other words, alternative investments may not be listed on national exchanges or over-the-counter markets, and quoted market prices may not be available from the stock exchanges or the National Association of Securities Dealers Automated Quotations System (NASDAQ),²⁵ which are usually sources of fair value for more traditional investments.

Despite the difficulty of estimating a fair value for alternative investments, they must generally be stated at their fair value and management is responsible for determining the fair value. The *Practice Aid* states that "management of the investor entity is responsible for the valuation of alternative investment amounts as presented in

the investor entity's financial statements" and "this responsibility cannot, under any circumstances, be outsourced or assigned to a party outside of the investor entity's management."²⁶ This means that although management may look to the fund manager for the mechanics of the valuation, management of the endowed institution must be able to independently evaluate and either accept or challenge the fund manager's valuation. In order to take responsibility at this level, management must have an effective process and controls in place as well as a sufficient understanding of the fund's investment strategies, operations, underlying investments, and valuation procedures.

An institution with an effective valuation process would obtain and formally review the fund's financial reports (e.g., independently audited financial statements, monthly statements), and summarize the results of that review in a memorandum. Ideally, the fund's reports would include a detailed listing of the underlying investments and their fair values. In the absence of detailed data, the institution would request other summarized data, such as condensed portfolio data, sector data, etc., that the fund may be willing to provide. The institution might regularly conduct telephone or in-person interviews with the fund manager to understand the fund's valuation policies and procedures.

Chart 5: Recommended monitoring practices²²

Fund's communications	<ul style="list-style-type: none"> • Review fund communications (i.e., periodic reports, statements and other forms of communication). • Attend annual investor meetings, to the extent applicable. (Note that this is common for private equity funds.) • Obtain and review audited financial statements, noting whether the opinion is qualified and, if so, why. Also note whether there was a change of auditors or a change in valuation policies or other unusual disclosures associated with related party transactions or otherwise. • Compare partners' capital statements²³ with internal transaction records. • Review SAS 70 reports,²⁴ if available, and ensure that identified user controls are in place. • Monitor communications for possible mismatch of liquidity terms or for "style drift" (that is, the tendency of a fund manager to alter his or her investment style such that it drifts away from what was originally agreed to).
Fund's key personnel	<ul style="list-style-type: none"> • Review press reports for significant management/structure/personnel developments. Inquire about staffing level changes. • When key personnel changes occur, consider making background checks, asking for and checking references, and searching the NASD and SEC websites on page 8 (see Chart 4).
Internal processes and controls at the institutional level	<ul style="list-style-type: none"> • Review internal controls over capital calls to ensure that they are appropriately authorized. • Ensure appropriate involvement by the institution's tax professionals, including an annual review of Schedule K-1 for each investment, as applicable, to determine if it has resulted in unrelated business income or IRS reporting considerations. • Clearly define and document quantitative/qualitative goals that are used to award compensation to the institution's investment professionals. • Assess conflict-of-interest policies for the institution's investment managers as well as its board members. (Investments in funds or affiliated organizations managed by board members are related party transactions, which should be subject to additional transparency and possible approval by the board.)

Fund-of-funds

Determining the fair value for investments in a fund-of-funds presents additional challenges. Obtaining the detailed investment holdings of a fund-of-funds (such as underlying funds are often referred to as “portfolio funds”) may not be possible or practical. Nonetheless, institutional management should gain an understanding of the strategies of the portfolio fund. In addition, management should evaluate the fund-of-funds’ due diligence and ongoing monitoring controls over the underlying portfolio funds.

Many institutions invest in fund-of-funds vehicles to access the sophistication of the fund-of-fund’s manager. However, institutions still retain the responsibility for pre- and postinvestment due diligence and valuation, and must review the fund-of-funds valuations to ensure their reasonableness.

In Chart 6, we summarize the recommended actions related to the financial reporting and valuation for all types of alternative investments, including a fund-of-funds.

Valuation may present the biggest single challenge of alternative investments, but a robust valuation monitoring process that is well documented is essential, and it becomes increasingly important as the size and complexity of the portfolio of alternative investments increases. Institutions should expect their independent auditors to focus on valuation issues. It would be a good idea to discuss with the auditor—sooner rather than later—what audit

Chart 6: Recommended valuation monitoring and oversight practices²⁷

- Compare the net asset value (NAV) received by the institution at the fund’s year-end date (often December) to the information included within the fund’s audited financial statements. Determine if the return percentages match and if the NAVs differ. Follow up on significant discrepancies.
- Track valuation statements for timeliness.
- Obtain the fund’s Forms K-1 and review for any federal and state tax liability. Also, see if the capital account information reflected in the Forms K-1 is consistent with the capital account information provided by the fund manager.
- Reconcile the fund’s valuation statements with the value included on the custodian statement. Follow up on significant discrepancies.
- For hedge funds, consider whether the fund’s estimated NAVs are generally consistent with the final NAVs received from the fund manager or administrator and understand reasons for large or unusual variances.
- On a regular basis, conduct phone calls with, or visits to, the fund to understand the fund’s valuation policies and procedures, including the valuation methodologies.
- Request and review any changes to valuation policies and procedures. Inquire as to whether the valuation process employed by the fund manager is consistent throughout the year or whether the fund manager employs a less extensive process for interim valuations.
- Compare the valuation policies and procedures across different funds that hold the underlying investments to identify potential differences in methodologies or key inputs. Ask a fund manager to explain any differences in methodologies or inputs.
- Compare the fund’s performance to benchmark returns,²⁸ to the extent applicable, to see if the expected return is reasonable.
- When valuations change significantly, find out what caused the change and consider the reasonableness of the explanation. (This can be particularly relevant for private equity funds with a discrete number of private investments whose values do not tend to generally fluctuate period to period.)
- Compare cash distributions to previously reported values throughout the year.
- Inquire periodically as to the composition of the investment portfolio, such as the total long and short positions throughout the year (primarily for hedge funds).
- Review information provided on the fund’s portfolio holdings on a regular basis. Note any significant capital changes (up or down) for the fund and the fund manager’s assets under management.
- Assess the existence of any side-pocket²⁹ investments held by the fund and any related valuation policies and procedures.
- Document the actions that the institution has taken to determine the fair value of its alternative investments.

evidence the auditor will expect from the institution to support adequacy and reasonableness of the valuation.

Financial reporting

As discussed in the previous section of this paper, management is responsible for determining the fair value of alternative investments. In addition, the investment office and the controller's office should take other actions to coordinate the financial statements preparation and get ready for the annual audit. These actions are summarized in Chart 7.

Management also must prepare the footnote disclosures to the financial statements. Footnotes are an integral part of the financial statements, and must comply with Generally Accepted Accounting Principles (GAAP). Certain disclosures are required to meet GAAP standards, but others are voluntary and designed to enhance the transparency of an institution's financial statements. We provide several recommendations in Chart 7.

The goal is to produce complete and accurate financial statements that are clear and prepared in a manner that users can easily understand. In the current environment, users of financial statements have increasingly high expectations about transparency.

Chart 7: Recommended financial reporting practices³⁰

Actions for the investment and controller's offices

- Coordinate financial reporting responsibilities between the investment and the controller's offices.
- Consider financial reporting controls over key investment transactions, including interest and dividend income and expense, realized gains and losses, and the change in the valuation at the end of the period with resultant impact on unrealized gains or losses.
- Maintain a list of alternative investments grouped by fund manager, investment strategy, etc. It will be helpful during the annual audit as well as for preparation of required tax filings.
- Review the most recent audited financial statement of each fund, noting basis of accounting, summary of significant accounting policies and procedures pertaining to the valuation of alternative investments, name of audit firm, and type of opinion.
- Compare investment balances reported by the fund manager to the amount reflected in the institution's general ledger.
- Monitor the level of the ownership of the fund to determine proper accounting method (for certain types of investor entities).
- Clearly describe the valuation policies used—there should be no ambiguity about how alternative investments are valued.
- Report alternative investments separately and clearly in the institution's financial statements. Consider disclosing the percentage of the portfolio invested in different alternative asset classes or strategies, such as private equities, absolute return, distressed securities, venture capital, and others.
- Disclose the risks of investing in alternative investments in the financial statements. Consider market, liquidity, valuation, credit and other risks.
- Disclose capital commitments that often exist for private equity and venture capital funds. (In some cases, significant, long-term funding is required, which could affect an institution's liquidity.)

Implementation issues

We have recommended many practices in this paper. Implementing them will take time and resources. Important questions include who should implement them at your institution and where they should start.

Resources

Earlier we mentioned the December 2006 NACUBO webcast on alternative investments. Approximately 185 participants offered valuable data about the “as is” situation for most institutions when they responded to polling questions during the webcast. For example, we asked the participants in the NACUBO webcast where their existing resources related to alternative investments resided within their current organization. Chart 8 shows their answers.

As you can see from Chart 8 (see next page), their answers varied widely. Institutions are using a variety of resources to support their alternative investments.

In our experience with fiscal 2006 audits, larger institutions rely on specialized resources in the controller’s office and the investment office. Accounting for external financial reporting is usually the responsibility of the controller’s office while managing the alternative investment portfolio is the responsibility of the investment office. More of the overall responsibility for alternative investments falls on the controller’s shoulders at smaller institutions. Quite a few institutions also use an external investment consultant for some selection and monitoring activities.

Do institutions believe they have sufficient resources to perform due diligence, monitoring, valuation and reporting activities?

We asked the participants in the NACUBO webcast this question. Approximately 34 percent either strongly agreed or agreed that their resources were sufficient, leaving the majority—66 percent—believing that their resources were not sufficient.

What is an appropriate level of resources?

The focus on due diligence and monitoring in the *Practice Aid* and *Interpretations* is likely to increase the contact between fund managers and institutions. As a result, an institution’s trustees, investment professionals, business officers, tax professionals, general counsels and others need to collectively assess and determine if there are adequate resources over the following:

- Effectiveness of the institution’s pre- and postinvestment due diligence programs
- Knowledge, experience and training of the personnel responsible for its pre- and postinvesting due diligence programs
- Documentation and other evidence available to support its due diligence programs
- Linkage between those responsible for performing and documenting the due diligence and those responsible for accounting and financial reporting for such investments
- Understanding of valuation policies and methodologies

Some initiatives might require more resources up front but then a smaller number to sustain them over time. For example, an institution might redeploy staff to enhance documentation for a short period. Other institutions might dedicate more full-time resources to alternative investments. It might be useful to periodically graph the number of personnel in an institution’s investment office against the number of its investments to make sure that its resources keep pace. If your alternative investments portfolio has grown by 50 percent in ten years, you have three new asset classes, and your internal or external resources have not changed, you may need to increase the number of personnel responsible for alternative investments.

Some institutions might decide to invest in information technology systems. Systems can play an integral role in the monitoring, oversight, and reporting of alternative investments. Some are designed specifically to track and monitor domestic and offshore hedge funds, for example, or funds-of-funds with partnership accounting and analytical tools. They make it possible to track cash investments in, and distributions from, limited partnerships on a periodic basis by individual partnership as well as compare valuations of similar nonpublic holdings across multiple partnerships.

One thing has become clear. Investment professionals should not be distracted from doing what they do best—searching for new opportunities, recommending investment decisions and monitoring performance. Some institutions have hired a

business manager in the investment office who is responsible for facilitating the ongoing communications with the controller's office as well as certain aspects of pre- and postinvestment monitoring and valuation.

Communication and training

Before hiring new resources, it is important that the current resources fully understand their roles and responsibilities. Communication and training programs can be as informal as one-on-one conversations to explain why, for example, certain policies are important and how the related procedures should be performed, or they can be formal, classroom-based training programs with minimum proficiency requirements.

Given the complexity and risk of alternative investments, adequate communication and training are essential. We recommend practices related to communication and training in Chart 9.

Due diligence, valuation and financial reporting controls/processes are most effective when people understand the objectives and the reasons behind them. Generally speaking, the larger and more decentralized an institution is, the more important formal communication and training programs are.

Chart 8: Where do alternative investment resources currently reside?

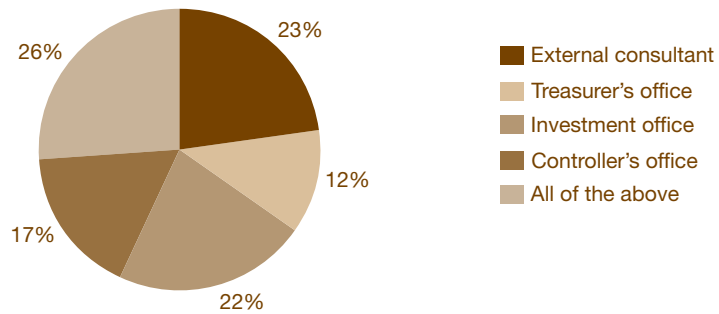


Chart 9: Recommended communication and training practices³¹

- Open the lines of communication; take the time to understand the roles and responsibilities of all of the parties, including the:
 - Independent auditors. What audit procedures will they perform, and how does the complexity, liquidity and volatility of the alternative investments impact the nature, timing and extent of those procedures?
 - External fund managers. What controls and processes have they established, documented and shared with the institution?
 - Other external parties (e.g., valuation specialists, investment consultants), if applicable. What are their responsibilities and how do they satisfy them? What information is shared with the institution, in what form and how often?
 - Internal constituents. Do the members of the audit committee, investment committee, investment office and controller's office fully understand how their roles and responsibilities align?
- If gaps in understanding are found, design appropriate communication and training programs.

Where enhancements are needed

Where should institutions focus their new or existing resources? Again, the NACUBO webcast provides a starting point. With regard to due diligence and documentation, the webcast participants were asked the extent to which they agreed with four statements, the first of which related to preinvestment due diligence. Their responses are depicted in Charts 10, 11, 12 and 13.

According to this data, most institutions believe that their oversight of valuation as well as their preinvestment and postinvestment due diligence practices are adequate (i.e., 65 percent in Chart 11 and 77 percent in Chart 10). Fewer institutions believe that their documentation of due diligence and valuation practices is adequate (i.e., 45 percent in Chart 12 and 38 percent in Chart 13). We believe this is also an important finding, and one with which we would concur. Auditors have been known to say, “If it isn’t documented, we can’t audit it.” Some recommended documentation practices are presented in Chart 14 (see next page), although this list is not meant to be all-inclusive.

It would be prudent for management to expect—and prepare for in advance—the external auditor’s request for supporting documentation related to the institution’s due diligence and valuation practices.

Chart 10: Are your institution’s preinvestment due diligence practices adequate?

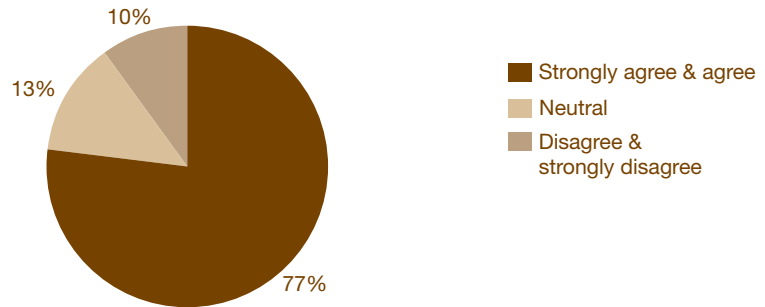


Chart 11: Are your institution’s postinvestment due diligence and valuation oversight practices adequate?

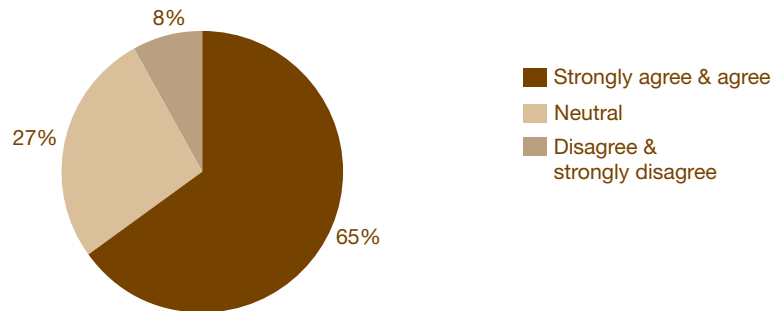
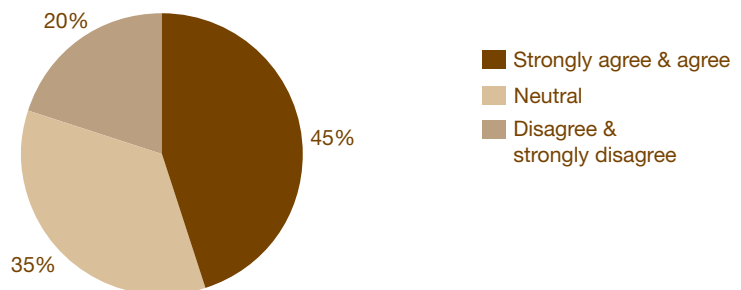


Chart 12: Are your institution’s documentation of pre- and postinvestment due diligence practices adequate?



Where should you start?

How would you rate your institution's pre- and postinvestment due diligence and documentation practices? Think about how you would have responded to the webcast polling questions. Would you have said that oversight of valuation as well as preinvestment and postinvestment due diligence practices are adequate? Would you have responded that your documentation practices were sufficient?

We suggest that you review what you have in place against the recommendations in this paper, particularly those in the Charts. If you start by simply documenting the practices that you already have in place, you will be better prepared for your FY'07 audits. Then you can consider what other enhancements might be needed. For example, should your institution's preinvestment due diligence or postinvestment monitoring be enhanced? Take into account the design and effectiveness of due diligence programs as well as the documentation that supports them.

Chart 13: Are your institution's documentation of valuation practices adequate?

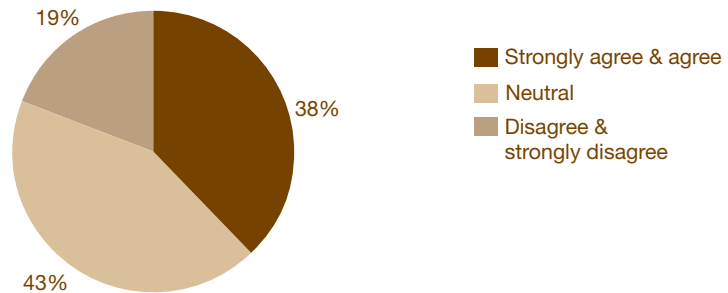


Chart 14: Recommended documentation practices

Samples of Key Controls	Documentation Practices	Generally Required for Audit?
Selection, evaluation of fund managers	<ul style="list-style-type: none"> • Written due diligence memos • Formal due diligence checklists • Written minutes of meetings where decisions were made 	Yes
Periodic visits or phone calls to fund managers	<ul style="list-style-type: none"> • Written documentation of visits or discussions; a formal checklist or handwritten notes would be acceptable 	Yes
Investment policy for asset allocations and valuations	<ul style="list-style-type: none"> • Written policy that has been adopted/ approved by investment committee; policy exceptions should be presented to the full committee for acknowledgement 	Yes
Review of audited financial statements	<ul style="list-style-type: none"> • Written checklist that may include: <ol style="list-style-type: none"> a) reconciliation of audited financial statements to recorded balance, b) rollforward of audited balance from fund's year-end to institution's year-end, and c) comparison of actual returns to benchmarks, and explanations of significant variances 	Yes
Review of valuations prepared by fund managers. Include review of holdings and assumptions used	<ul style="list-style-type: none"> • Written notes on valuations or separate memo documenting acceptance by investment office 	Yes

Conclusion

Many institutions have achieved excellent annual returns by investing in alternative products, such as hedge and private equity funds. However, institutions should manage the risk of such investments by ensuring they have the proper infrastructure in place as well as adequate policies and procedures.

Essential elements to manage the risk of alternative investments are:

- **Institutional valuation risk assessment:** The institution should develop a valuation risk assessment that identifies the significant valuation risks within the portfolio and aligns them with a defined set of policies and procedures. Such policies and procedures should be designed to manage and monitor the valuation risks.
- **Preinvestment due diligence:** The process that institutions use to select alternative investments should be robust and well documented. We recommend utilizing a selection checklist to make the process consistent.

Preinvestment due diligence should include an evaluation of the fund manager and key team members. Also, institutions should ensure that they are comfortable with the fund's strategy and risk profile as well as the tax, liquidity, valuation and other issues that may arise. They should make sure that the fund has adequate controls and procedures in place and that the institution's resources are

adequate to manage the risk. Finally, they should ensure that the investment has been fully discussed with, and approved by, all relevant parties, including the board.

- **Postinvestment monitoring:** Postinvestment monitoring should be as strong as preinvestment due diligence. The fund's systems, policies, procedures and controls should be effective, as should the institution's ability to monitor the fund. In addition, the institution should monitor all communications from the fund and perform a detailed review of those communications that contain performance and valuation metrics.
- **Valuation monitoring:** It is necessary to value alternative investments at fair value for financial reporting purposes. In general, there is a direct relationship between the size of the alternative investments portfolio and the depth and breadth of the institution's monitoring. The larger the institution's investment in the alternative asset class, the more comfort the institution must have in the fund's valuation process and the more in-depth its review of valuations should be.
- **Documentation:** Documentation is a necessity. It provides evidence of effective internal controls. It records the work that management has performed with respect to its alternative investments portfolio. Consider incorporating various ways to docu-

ment activities on a contemporaneous basis. It may take various forms (e.g., notes, memos, narrative, procedural write-ups, flowcharts); it may be formal or informal; and its extent is likely to vary depending on the significance of an institution's investment and other factors. But, it must exist.

- **Communication and Training:** Everyone involved in the process—the alternative investment fund, external auditor, third-party service provider, controller's office, investment's office, and board members—should be fully informed of their roles and responsibilities as well as those of the other parties in the process. Training might be necessary to raise the level of understanding of these parties.
- **Resources:** Institutions should devote sufficient resources to balance the risk of investing in alternative strategies, but how much is enough? Ultimately, each institution needs to weigh the costs of investing in alternative strategies against the returns, and decide what constitutes an appropriate level of investment in human and systems resources. A critical point is that institutions should weigh the full costs, including the people who are needed to monitor alternative investments, against the potential returns.

Generally speaking, institutions with larger endowments have larger, more sophisticated staff to monitor their complex portfolios and manage their risk. The decision is

harder for institutions with smaller endowments that may not currently have many resources devoted to managing the risks associated with their alternative investment portfolio. At what point are the demands associated with this asset class greater than an institution's current infrastructure? We don't have a definitive answer, but we urge institutions to consider the question and involve the board as well as senior officers in the decision process.

Implementing the practices in this paper that are relevant to your institution and the size of its investment in alternative products will help manage their risk. Despite the fact that alternative investments have yielded excellent returns to date, institutions must not become complacent about their responsibilities to effectively monitor such investments and manage the related risks.

Endnotes

1 Our 2004 paper, *Managing the Challenges of Alternative Investments*, may be found on our website at www.pwc.com/education under "Publications."

2 *Alternative Investments—Audit Considerations: A Practice Aid for Auditors* was published by the AICPA and is available at www.aicpa.org, page 1.

3 A "lock-up period" is the amount of time a limited partner is required to keep his or her money in the hedge fund before redeeming it.

4 A "gate" is a provision under which a fund manager can defer an investor's redemption requests because the aggregate amount of redemption requests as of a particular redemption date exceed a specified level.

5 From The 2007 NACUBO Endowment Study, conducted in conjunction with TIAA-CREF, published in 2007, and based on 2006 data. The survey results are posted to NACUBO's website at www.nacubo.org. The average is for all the institutions that participated in the survey.

6 From testimony on the regulation of hedge funds, by Chairman Christopher Cox, SEC, before the U.S. Senate Committee on Banking, Housing and Urban Affairs, July 25, 2006, posted on www.sec.gov.

7 From the 2007 NACUBO Endowment Study that was conducted in conjunction with TIAA-CREF. See footnote 5.

8 From a January 10, 2007 Commonfund press release ("U.S. Higher Education Endowments and Foundations Report Average Return of 10.6 Percent in Fiscal Year 2006, up from 9.7 Percent Last Year") on its website at www.commonfund.org. The Commonfund manages approximately \$38 billion for more than 1,600 nonprofit institutions.

9 "Endowments Celebrate a Streak," *The Chronicle of Higher Education*, January 26, 2007.

10 Moody's Investors Services, *Moody's 2006 Higher Education Outlook*, February 2006, page 5.

11 The two AICPA Interpretations are AU Section 9332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, and AU Section 9328, *Auditing Fair Value Measurements and Disclosures*.

12 See footnote 2 about the *Practice Aid*.

13 A positive external confirmation request asks the respondent to reply to the auditor in all cases either by indicating the respondent's agreement with the given information, or by asking the respondent to fill in information. A response to a positive confirmation request is ordinarily expected to provide reliable audit evidence.

14 When the external independent auditor conducts an audit, the auditor tests whether or not the institution has prepared its financial statements in accordance with Generally Accepted Accounting Principles (GAAP). A paragraph in the independent auditor's opinion states whether the financial statements comply with GAAP. If they are in compliance, the auditor usually gives an "unqualified" opinion. Having an unqualified opinion is important because it means that an independent auditor has found nothing to indicate that the financial statements are materially misstated.

15 Although essential information is disclosed in the financial statements or in the footnotes, the auditor may include an "emphasis of a matter" paragraph to emphasize certain facts in the auditor's report even though it is an unqualified report. With respect to alternative investments, the auditor may want to emphasize that the value of certain alternative investments has been estimated by management in the absence of readily determinable fair values.

16 This list is not meant to be all-inclusive. The practices in Chart 4 are from a variety of sources including PricewaterhouseCoopers' 2004 paper, *Meeting the Challenges of Alternative Investments* and the AICPA's *Alternative Investments—Audit Considerations: A Practice Aid for Auditors*. Other sources may include the December 2006 NACUBO webcast and PwC internal materials.

17 NASD is a private-sector regulator of the securities industry; its website has information about NASD-registered firms and registered brokers. According to Section 3 of the Securities and Exchange Act of 1934 (at www.sec.gov), a broker is: "any person engaged in the business of effecting transactions in securities for the account of others."

18 According to Section 202 of the Investment Advisers Act of 1940 (at www.sec.gov), an *investment advisor*: "engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities." Investment advisors must register with the SEC using Form ADV, which is posted at: www.adviserinfo.sec.gov. Investors can view the investment advisor's ADV, find out his or her registration status, and look at the disclosures, if any, about disciplinary events involving the advisor or key personnel.

19 See footnote 18.

20 From testimony by Susan Ferris Wyderko, Director, Office of Investor Education and Assistance, SEC, before the Subcommittee on Securities and Investment of the U.S. Senate Committee on Banking, Housing, and Urban Affairs, May 16, 2006, posted at

www.sec.gov.

21 Some funds (primarily private equity funds) have advisory boards that include representatives from key investors. Institutions can gain a great deal of insight about their investment by participating on such boards should an invitation be extended to them.

22 This list is not meant to be all-inclusive. The practices in Chart 5 are from a variety of sources including PricewaterhouseCoopers' 2004 paper, *Meeting the Challenges of Alternative Investments* and the AICPA's *Alternative Investments—Audit Considerations: A Practice Aid for Auditors*. Other sources may include the December 2006 NACUBO webcast and PwC internal materials.

23 A fund's capital statement provides an analysis of the availability of capital to meet risks and regulatory requirements.

24 Some fund managers might ask their external auditors to prepare a SAS 70 report on the auditor's review of the fund's internal controls. SAS 70 stands for Statement on Auditing Standards No. 70, *Service Organizations*, which was issued by the AICPA in 1992. Also, some fund administrators may have a SAS 70 report.

25 AICPA's *Practice Aid*, foreword. See footnote 2.

26 AICPA's *Practice Aid*, page 4. See footnote 2.

27 This list is not meant to be all-inclusive.

28 For instance, a fixed income hedge fund may be able to provide data (e.g., duration of the portfolio, weighted average maturity, weighted average coupon, portion of the portfolio that is hedged) that will enable the institution to track the fund against observable benchmarks. Another example would concern a fund invested in over-the-counter derivatives. The fund may be able provide information, such as the portfolio's sensitivity relative to a benchmark (e.g., the delta of the portfolio), that the institution could track against an observable market, such as energy futures.

29 Funds sometimes move hard-to-value assets into a "side-pocket" until they are liquidated or an event occurs that enables fund managers to value them with more precision.

30 This list is not meant to be all-inclusive.

31 This list is not meant to be all-inclusive.

Appendix

Higher Education Publications

The following publications are available for downloading at no charge at: www.pwc.com/education.

PwC's commitment to continuous thought leadership is evidenced by the depth of our work. Over the past three years, we have developed a series of white papers, points of view, and newsletters for higher education institutions around the areas of governance, financial reporting, internal controls and risk.

Papers

Achieving Goals, Protecting Reputation: Enterprise Risk Management for Educational Institutions, published in 2006, discusses how enterprise risk management can work in the higher education environment.

Enhancing the Transparency of Financial Reporting, published in 2006, is designed to frame the issues and guide the discussion of voluntary transparency as it might broadly apply to the financial reports of colleges and universities.

Taking the Right Path: Sarbanes Summit, published in 2006, captures the recommendations of college and university presidents and business officers about how they might enhance governance, internal controls, certification and risk management on their campuses. This paper was published jointly by PricewaterhouseCoopers and NACUBO.

Accounting for Asset Retirement Obligations: An Education & Nonprofit Perspective, published in 2006, discusses new FASB pronouncements that require institutions to recognize legal obligations associated with the retirement of long-lived assets, such as facilities with asbestos-covered pipes.

Internal Controls: The Key to Accountability, published in 2005, is designed to help trustees, business officers and other senior managers of public and private research universities as well as smaller private colleges understand the components of an effective system of internal controls as well as how internal controls can be enhanced.

The Changing Role of the Audit Committee: Leading Practices for Colleges, Universities, and Other Not-for-Profit Educational Institutions, which was published in 2004, recommends that audit committees consider implementing certain best practices that are emerging. Samples of documents—such as an audit committee charter—that we consider best practices are included.

A Foundation for Integrity, published in 2004, provides board members and senior executives with an overview of the issues surrounding codes of conduct, conflicts-of-interest and executive compensation.

Meeting the Challenges of Alternative Investments, which was published in 2004, highlights four fundamental issues posed by alternative investments, selection, monitoring, valuation, and reporting.

Summary of Emerging Technical Issues for Colleges and Universities in 2007, which will be published shortly, includes brief summaries of accounting, financial reporting, tax, and regulatory compliance issues that we think will affect colleges and universities in the near future.

Summary of Emerging Technical Issues for Not-for-Profit Organizations in 2007, which will be published shortly, includes brief summaries of accounting, financial reporting, tax, and regulatory compliance issues that we think will affect charitable organizations in the near future.

Points of View

PricewaterhouseCoopers also develops short, focused “points of view” on selected topics. Our recent points of view include the following:

Compensation of Key Employees and Intermediate Sanctions: How Does Your Organization Stack Up, published in 2006, recommends that institutions develop appropriate compensation policies and procedures for highly compensated employees.

SAS 112 Internal Controls Readiness, published in 2006, recommends that institutions attend to the deferred maintenance in their control environments. The reason is that the AICPA issued a new auditing standard that incorporates new definitions of significant deficiency and material weakness, making the definitions used for audits of nonpublic entities consistent with those already in

place for audits of public companies. The new definitions lower the threshold for reportable control deficiencies, and are likely to cause more deficiencies to rise to the level of significant deficiencies and material weaknesses, which must be reported in external financial statement audits.

The Importance of Training Programs, published in 2005, discusses how training is an essential building block for enhancing financial effectiveness.

The Intellectual Property Horizon, published in 2005, discusses the importance of clearly defining the institution's intellectual property policies. For example, is the institution willing to fund the "innovation gap" until the start-up is sufficiently robust, and does it have sufficient resources to do so? In addition, is the institution willing to actively participate in local economic development and, if so, to what extent?

Managing Technology Risk, published in 2005, provides readers an organizational framework that can be utilized to help identify areas of risk, and assist in assessing and managing such risks.

Enhancing Financial Reporting Controls Beginning with the Closing Process, published in 2005, is centered on internal controls over financial reporting as they relate to the closing process.

Exempt Tax Newsletters

Charitable Giving Incentives and Charitable Reforms: Highlights from Title XII of the Pension Protection Act of 2006 discusses the Pension Protection Act of 2006, which was signed into law in August 2006. The Act focuses primarily on traditional pension plans and retirement benefits, but it also includes measures that are designed to provide new incentives and tighter oversight of tax-exempt organizations.

April 15 Deadline for Filing Protective FICA Refund Claims Associated with Faculty Tenure Buy-Outs discusses the FICA refund deadline, which is particularly important for colleges and universities that have or had early retirement plans.

Mandatory Electronic Filing of Form 990 Now a Reality provides important information about filing electronically.

Election-Year Focus on Lobbying and Political Activities of Charities discusses allowable lobbying versus political activities, which have distinct IRS definitions and different rules.

Spring 2006—Congress and IRS Continue to Focus on Exempt Organizations discusses certain issues that were finalized in the Pension Reform Act (see newsletter mentioned above: *Charitable Giving Incentives and Charitable Reforms: Highlights from the Title XII of the Pension Protection Act of 2006*) but it also includes a discussion of the revised Form 990 and an IRS report on examinations of political activities by churches and charities.

Regulatory Outlook

Regulatory Outlook is a new PricewaterhouseCoopers' newsletter that is designed to help keep business officers up-to-date on the most critical regulatory compliance challenges facing today's colleges and universities. Volume I focuses on the new "Yellow Book" regulations that the Government Accountability Office (GAO) has proposed. Volume II provides updates on several federal regulatory issues.

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