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AUDITING ALTERNATIVE INVESTMENTS:
An Endowment Investment Perspective

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AUDITING ALTERNATIVE INVESTMENTS:
An Endowment Investment Perspective

Note: The following discussion is intended as a review of the implications of the "Practice Aid" recently issued by the American Institute of Certified Public Accountants (AICPA) as guidance to auditors of institutions with investments in alternative assets, strictly from the perspective of investment planning. As is evident in this paper, specific audit advice can come only from an institution's audit team. Because investment officers at some institutions regularly work with auditors, while at other institutions only rarely do so, portions of this working paper may be more familiar to some readers than to others. The paper itself is based on discussions with major auditing firms, careful examination of the "Practice Aid," Cambridge Associates' extensive familiarity with alternative asset managers and the concerns of our clients, and a review of the recent writings and presentations on the subject.

Background

During 2005 the auditing of alternative assets came under close scrutiny by the AICPA. In responding "no" to a very specific inquiry about whether a particular kind of "audit evidence" would be sufficient to confirm the valuation of an alternative investment,[1] the AICPA opened the door to an intensive year-long discussion of what *would* constitute adequate evidence. In mid-July 2006, a clarification was issued in the form of a 22-page document titled *Alternative Investments – Audit Considerations: A Practice Aid for Auditors* (hereafter referred to as the *Practice Aid).*[2] This document is not mandatory for auditors and has "no authoritative status." It is offered by the AICPA as guidance that "may help" auditors as they address alternative assets. Nevertheless, driven by the *Practice Aid,* the likely changes in auditing approach may bring significant challenges to many if not most endowment investment offices.

For those who are neither auditors nor accountants, some background may be helpful. The basic substructure of the discussion of valuation of alternative assets for financial statement purposes rests in the accounting literature governing "fair valuation" of investments. The *Practice Aid* does not change the accounting rules, nor does it fundamentally change auditing standards. What it does change—or, more accurately, has made more specific—is the AICPA *guidance* pertaining to these "more esoteric" investments.[3] This guidance has emerged during a time of increased media coverage of hedge funds, often accompanied by the sounding of alarms. Coincident with and partly driving this has been the much increased allocation to alternative assets in many investment portfolios held by nonprofit institutions and pension funds.

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[1] From AU Section 9332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities:* "Does receiving a confirmation from a third party [e.g., a fund manager], either in aggregate or on a security-by-security basis, constitute adequate audit evidence with respect to the existence and valuation assertions in SAS No. 92?" Answer: no. [brackets added] The foremost auditing standard for investments is AU Section 332. The number "9" indicates that the statement is an interpretation of AU Section 332. Hence the much-discussed AU 9332 of 2005.

[2] The *Practice Aid* is available at many websites, such as www.nacubo.org.

[3] *Practice Aid,* p. 8.

Many of these investors have been allocating a portion of their portfolios to alternative assets for several decades. During this time they have developed a familiarity with these asset classes that translates into substantial comfort with the reports and communications they receive from fund managers both directly and through consultants and funds-of-funds. Most are very knowledgeable about these assets and apply educated judgment to the valuations reported to them. Some have developed a highly explicit and documented process for judging and accepting (or challenging) these reports; others have not. Some exercise highly sophisticated judgment but with less formal process and documentation. The new audit guidance in the *Practice Aid* is likely to require institutions (referred to as "management") to become formal and explicit in their valuation process, and to document this.

The timing of the release of this new audit guidance in July 2006 poses a tremendous challenge to many institutions, since it gives those with a June 30 fiscal year little time to react. Also, as is well-known to those who work directly with external auditors each year, the auditors' judgment of both the institution's endowment management and asset valuation *process* and the *internal controls* related to that process will determine the audit plan that is devised for any given institution. The greater the auditors' comfort with management's process and controls, the less daunting the audit plan will be. Or, conversely, the greater the auditors' discomfort, the more challenging the audit plan.

To be sure, as a practical matter, the very late release of the *Practice Aid* may cause some audit engagement teams to accept some of the work-arounds that were used in 2005, when there was similar uncertainty about how best to audit alternative asset valuations. The difference between last year and this year, however, is that the subject is closed, from the point of view of the AICPA, now that the *Practice Aid* has been issued. A given audit team assigned to a given institution might permit some or all of the audit practices in place last year—depending of course on the content of those practices and a long list of considerations relating to the specific client (which are described later in this text). But this cannot be counted upon. Nor is it likely to persist beyond the financial statements for this 2006 fiscal year.

Auditors and Investors: The Twain Now Meet

There are numerous ways in which institutional investors and auditors have different frames of reference:

- *Very different definitions of risk.* Investors focus on various kinds of portfolio and related risks, while auditors are obliged to weigh the "inherent risk" that an asset valuation at a particular date (the "valuation assertion") is sufficiently inaccurate that there is a material misstatement on the institution's balance sheet, or that the purported asset does not even exist, nullifying the "existence assertion." A second risk is the "control risk," namely that *were there* a material misstatement, it would not be prevented or detected by management's internal control system.

- *Entirely different goals.* Institutional investors seek maximum investment return within stated (investment) risk parameters; indeed, the entry into alternative assets has been undertaken to *reduce*

portfolio risk, through diversification. Endowments' time frame is usually the long term, or at least the future, however long or short. Auditors seek an accurate measurement of an asset at a *past* point in time (fiscal year end); their formal approach does not give explicit weight to the role of that asset in the total portfolio, nor to long-term investment performance as such.

- *Different ranges of concern.* Investment committees and investment officers are focused primarily on the endowment and its performance, and (usually) the capacity of the endowment to support the endowment spending that is part of the institution's budget. Auditors have different and arguably broader concerns, inasmuch as they must also worry about the size of the endowment relative to net assets and total assets, and also the possibility of material misstatements in other parts of the balance sheet, statements of activity (changes in net assets), and cash flows.

- *Different disciplines.* Investment committees and investment officers function within the discipline of the institution's Investment Policy Statement and such other processes and structures that are in place at the institution. Auditors function within the disciplines of accounting and auditing rules, guidelines, interpretations, and such—a world that is often completely alien to investment professionals. Moreover, some investment professionals are surprised by the latitude granted to individual audit teams to determine whether a given item is "material." They may even believe that this latitude increases the probability of lenient or sympathetic treatment—whereas auditors hold materiality judgments to be the essence of their profession.

Because of these fundamental differences, it is no surprise that some investment professionals[4] have not yet addressed the challenges posed by the *Practice Aid.* Some hope that because this publication describes itself as having "no authoritative status," the near-term auditing obstacles might lead to a revision in audit requirements. It would be a mistake, however, to conclude that the *Practice Aid* will be changed any time in the foreseeable future, or that external auditors will not turn to it for guidance whether or not they are required to. There is merit in developing a practical response before one's external auditors devise and establish an audit plan that is onerous in terms of time and effort.

A parallel impact may be felt at the trustee committee level. It is certainly possible that the board's Audit Committee—to which the external auditors report—will begin to focus on matters heretofore entirely within the purview of the Investment Committee. Because the Audit Committee is required to sign off on the annual financial statement, it may itself begin to seek "comfort" concerning the valuation of the investment portfolio. Consequently, institutions should assign to the Audit Committee at least one trustee who is highly knowledgeable about alternative assets.

[4] This includes institutional investors, fund managers, investment consultants, and others who dwell mainly in the world of investments. Institutional investment officers who are also chief financial officers (CFOs) are less likely to be sanguine about the implications of the *Practice Aid.*

Who Will Receive the Closest Scrutiny by Auditors?

The answer to this question is not definitive, but rather a statement of probabilities or ranges, none of which is offered with quantified parameters:

- *The higher the percentage of the endowment that is allocated to alternative assets,* the more "significant" these assets will be in the auditor's assessment of the risk of material misstatement on the balance sheet.

- *The larger the endowment (investment assets) relative to other assets on the balance sheet,* the greater the significance, as above. Thus, given the same percentage allocation to alternative assets, the college at which the endowment constitutes 44% of total assets will attract much closer scrutiny than will the museum where it is only 16% of total assets.

- *The greater the impact of the investment assets on the operating statement,*[5] the greater the significance. For example, some institutions register asset valuation changes directly in the "bottom line" (net assets), while others have them softened by spending rules that adjust endowment spending in line with a moving average of several years' asset valuations.

- *The greater the volatility of* ***other*** *items on the balance sheet or in operations,* the greater the significance. For example, if the institution has to deal with fluctuations in revenues from sources other than the endowment (or investments), then the auditors will be more concerned about material misstatements of investment assets—simply because their concern is with providing an opinion on the *overall* financial picture, not just the endowment.

- *The more "complex" or volatile the asset,* the greater the risk assessment by the auditor (i.e., risk of material misstatement, not investment risk). The term "complexity" suggests insusceptibility to easy measurement. Hedge funds, for example, are judged to be very complex because they are often partially or wholly opaque in terms of their underlying investments. Private equity and venture capital are considered complex because the valuation of most or all of their portfolio companies cannot be verified against published listings, unlike holdings of domestic common stocks and bonds, for example; moreover, lack of timeliness of audit reports is a problem. Illiquidity ("such as investments in natural resources or start-up entities") is also considered an attribute of "complexity."

In the view of auditors, all of the above increase the "inherent risk" of a misstatement. The last bullet point ("complexity") also represents a "control risk," which is the risk that management will fail to detect misstatements in its financial reporting. Both inherent risk and control risk are subject to considerable auditor judgment, such as:

[5] I.e., the change in net assets.

- Whether management is sufficiently knowledgeable about the valuation procedures and assumptions used by the (alternative asset) funds.

- Whether management is sufficiently organized and methodical in its effort to detect valuation errors or misrepresentations by the funds (i.e., whether it has robust valuation and internal controls processes in place).

- Whether management is under unusual pressure to perform—for example, competitive pressures in some industries,[6] performance pressure on individuals,[7] pressure to meet debt covenants, and so forth (the presumption being that management would have less incentive to uncover valuation problems).

Note that the higher the assessment of inherent risk, the lower must be the assessment of control risk. In other words, the greater the "significance" and "complexity" of the alternative assets, the greater the risk of material misstatement of the balance sheet, and therefore the more controls are demanded.

Who Will be in the Best Position to Respond?

Institutions with some or all of the following characteristics will be less discomfited by the *Practice Aid*'s audit guidance:

- *A December 31 fiscal close date.* Institutions that either have or are able to move eventually to a December 31 close date will have a less arduous valuation task. That is because most funds have a December 31 close date, and because the audited financial statements of funds with close dates identical to that of the institutional investor, are considered "high-quality" audit evidence (to be discussed later). Another obvious advantage in the near term is that such institutions have the benefit of a few more months to devise an appropriate response to the *Practice Aid,* which was issued in July.

- *A sufficient deployment of investment expertise.* This does not necessarily require a large investment staff. The point is to deploy sufficiently expert and generous investment resources, including the investment committee, investment and internal audit staff, and third-party expertise including consultants. A resource configuration that is strong in terms of education, training, and work experience will provide more "comfort" to an auditor than one without these characteristics.[8]

[6] Thus, for example, if the health care/hospital industry is considered to be under financial pressure at the time of the audit, then hospitals might be subjected to greater audit scrutiny.
[7] "While the likelihood of a 'rogue' professional may appear farfetched, particularly in an academic environment, incentive compensation based only on returns could be risky." PricewaterhouseCoopers, *Meeting the Challenges of Alternative Investments,* 2004, p. 7. Separately, the audit literature also identifies as problematic fund manager incentive compensation that is wholly performance based.
[8] Although the *Practice Aid* expressly rules out exclusive reliance upon "outsourced" expertise, with appropriate oversight the knowledgeable use of outside resources is taken into consideration. "Co-sourcing" is one term that has been applied to such an arrangement.

- *A sure grasp of the funds' valuation processes and assumptions.* Auditors are more likely to deem an institution capable of detecting valuation issues (whether at the due diligence, ongoing monitoring, or reporting stages) when the institution's staff and/or investment committee includes individuals capable of discussing the organization's investment choices knowledgeably, in depth, and at length.

- *A good working relationship with one's auditor.* Because "materiality" varies with each client and each year, it is particularly important that management and auditor develop a shared view of its definition *in situ,* despite the differing agendas of investors and auditors.

- *An auditor (audit team) familiar with investments.* There is no question that it is helpful when an auditor understands investment theory, processes, assumptions, history, objectives, risk parameters, and so forth. The more sophisticated the auditor, in terms of alternative investments, the less time required to acquaint him or her with the specifics of valuation.[9]

- *An audit team with an appropriate frame of reference.* If the audit team is very familiar with other institutions in one's "industry" (whether higher education, health care, museum, etc.), then the audit task can also be less arduous. This is because such auditors would have a better grasp of which audit steps under consideration can be easily accomplished, and which are difficult or impossible to accomplish, and thereby design a more effective audit plan.

Audit Evidence

Auditors require evidence, mainly in the form of documentation, to substantiate the accuracy of valuations and the robustness of controls. Because the "nature" of alternative assets is such that a "readily determinable fair value does not exist" (read: cannot be checked against published stock listings and other public data), auditors require a great deal more evidence to support the "existence assertion" and "valuation assertion" that underlie the financial statements. Translation: auditors want to be assured that the assets are there and that they are measured correctly. Because of alternative assets' relative lack of both transparency (hedge funds) and simple valuation methodology (venture capital and private equity), auditors require other ways to get around these problems.

[9] However, audit firms might draw upon the expertise of their own alternative asset fund practice partners.

In this regard, auditors consider some forms of evidence to be of "higher quality" and other forms to be of "lower quality."[10] Among the higher-quality forms of evidence are:

- Audited financial statements of fund managers with closing dates identical to that of the institutional investor;
- A "comprehensive management valuation process;" and
- Detailed (investment by investment) confirmation of the assets held by each fund and the investor's interest in each fund.

No single type of "higher-quality" evidence is absolutely required of all institutions. It is a matter of "more is better" and ultimately a matter of judgment by a specific audit team within the context of a specific institution. If an institution has difficulty coming up with higher-quality evidence, then it will likely be required to submit larger amounts of "lower-quality" evidence. Examples of lower-quality evidence cited in the *Practice Aid* are a management process that is "limited to booking to fund statement at year end" and "[fund manager] confirmation in the aggregate." Given the sense of the *Practice Aid,* it is almost certain that providing *only* these two kinds of evidence would be judged inadequate.

Clearly a very robust type of evidence is the audited financials of the fund managers. However, the closing dates of most fund managers are at variance with the closing dates of most endowments. Further, particularly with respect to venture capital and private equity, even an identical closing date does not guarantee timely year-end fund audits. Therefore, use of audited fund financials may require a "roll forward" process to bridge the gap between December 31 and the institution's closing date. This in turn requires information from the funds and the application of certain supporting "tests" and assumptions. It is safe to say that possible solutions are still in flux: for example, the degree to which auditors are prepared to rely on quarterly unaudited updates from the funds, and the specific assumptions used to test those updates.

Appendix 2 of the *Practice Aid* provides examples of other types of evidence. It is titled "Illustrative Examples of Due Diligence, Ongoing Monitoring, and Financial Reporting Controls."[11] While this is clearly labeled an "illustrative" piece, it may be used by some as a standard checklist—notwithstanding the fact that the *Practice Aid* specifically states that the examples in the Appendix are "not intended to be all-inclusive or

[10] In the audit literature, quality is referenced as "appropriate" audit evidence, and quantity is referenced as "sufficient" audit evidence. Thus:

> "Given the wide range of types of alternative investments, thoughtful assessment of the risk of material misstatement and evaluation of the sources of possible audit evidence to support the existence and valuation assertions are necessary to design effective audit procedures. Because of the assessed level of risk of material misstatement and the constraints on the availability of audit evidence, there may be circumstances where the auditor *may not be able to obtain sufficient appropriate audit evidence over the existence or valuation assertions."* [emphasis added] *Practice Aid,* p. 2.

This would presumably cause the auditor to lean toward a qualified opinion.

[11] Although the title specifies "controls," the content lists tasks that are part of investment selection, monitoring, and reporting processes as well as the controls related to these processes. A typical description reads as follows: "Management should have in place a process and internal control over that process to ensure that its alternative investments are recorded at amounts in accordance with its stated accounting policies [presumably, GAAP]" *Practice Aid,* p. 5.

to be used as a checklist."[12] Clearly it should guide both an institution's investment office and its auditors. However, no single item on the checklist is necessarily a "must have" for all institutions, nor is there a guarantee that meeting every item on the checklist will provide sufficient comfort to the auditor. As with every other aspect of alternative asset valuations, the assessment can be made only within the context of a specific institution, by the specific audit team assigned to the task. With the publication of the *Practice Aid,* there have been indications that the national public accounting firms are attempting to develop additional nationwide practice guidance. This means greater consistency of judgments across all offices, *not* uniform requirements, and it is a work in progress.

Other than audited fund financial statements,[13] the only "must haves" are not specific checklist items, but rather the demonstration and documentation of process, methodology, and assumptions. Specifically, "management needs to establish an accounting and financial reporting *process* for determining the fair value measurements and disclosures, select appropriate *valuation methods,* identify and support any *significant assumptions* used . . ." [italics added][14] Management is *not* required to "recalculate" the fair values received from fund managers unless "it becomes aware that valuation methodology or assumptions used by the fund manager are incorrect, incomplete, or otherwise unsatisfactory."[15] It is likely that the lion's share of discussions with auditors will be around how to tackle nontransparent portions of fund portfolios and how to roll forward the valuations contained in the funds' audited financial statements to the close date of the institution.

With or without checklist, an institution[16] that is very knowledgeable and that is examined by auditors who are familiar with its investment processes will almost always fare better than an institution without these characteristics or advantages. Similarly, as noted earlier, an institution in which the endowment does not dominate the balance sheet or in which there are not the pressures on performance or heavy debt demands, has further advantages in this respect.

To sum up the need for audit evidence: the greater the "significance" and "complexity" of alternative investments—as described in the preceding section, "Who Will Receive the Closest Scrutiny by Auditors?"—the greater the need to supply audit evidence that is both "appropriate" (quality) and "sufficient" (quantity).

[12] Ibid., p. 6.
[13] These will be required although, as noted elsewhere, most will likely not have close dates identical to the institution's, and therefore will require a "roll-forward" valuation process acceptable to the auditor.
[14] Ibid., p. 4.
[15] Ibid., p. 5. For example, around 1999, at the valuation high point of the venture capital cycle, one major university unilaterally wrote down the valuation of its venture capital partnerships by as much as 40%, astutely anticipating the correction that followed soon after. One motivation for the write-down was the desire not to continue to pump up endowment spending.
[16] Including "management" and the investment committee.

Design of the Audit Plan

To the extent that auditors "obtain an understanding of internal control" at an institution, and have confidence based on that understanding, they will require less subsequent information. In other words, if management can provide the auditors with a clear description of its processes and controls with respect to due diligence, monitoring, and financial reporting, then the audit team can more readily design its audit plan. Thus, more and better information provided to the auditor upfront results in fewer follow-on requests that can lead to painful, protracted audits.

Control steps or "substantive procedures" such as those outlined in Appendix 2 "may not be practical or possible:"

> "It may not be practical or possible for the auditor to obtain sufficient audit evidence only from substantive procedures. Therefore, the auditor may (1) identify specific controls relative to specific assertions, (2) perform tests of controls, and (3) conclude on the assessed level of control risk. Such an assessment may result in a more effective and efficient audit."[17]

In other words, in testing selected internal controls, the auditors will apply judgment to determine whether processes and controls are sufficiently robust. Items specifically cited as "significant deficiencies or material weaknesses" in internal control are:

- "Lack of management understanding of the nature or extent of the alternative investments held by the entity or the risks associated with such investments.
- Lack of a comprehensive policy on strategy and objectives for investing in alternative investments.
- Lack of segregation of duties between authorizing and recording alternative investment activity.
- Failure to obtain appropriate [i.e., high-quality] information, including visibility into the underlying investments, to support the financial statement assertions relative to the estimate of fair value of assets of significant[18] alternative investments.
- Instances in which the alternative investment's risk profile does not appear to be consistent with the entity's investment policy."[19]

The only problematic item on this list is the one requiring "visibility" into underlying investments, as discussed above. It should be possible to meet the other conditions.

It is only after considering all of the above that the audit team assesses the risk of material misstatement. And it is only on that risk assessment (or degree of "comfort") that the auditor determines "the

[17] Ibid., p. 9.
[18] For a definition of "significant," see the preceding section, "Who Will Receive the Closest Scrutiny by Auditors?" on page 4.
[19] *Practice Aid,* p. 9.

nature, timing, and extent of the substantive audit procedures"—i.e., the audit plan. Audit procedures are not delivered from on high; their design is based upon judgments arrived at "on the ground."[20]

Audit Opinions[21]

There are several kinds of opinions that might be issued following an audit. These include, but are not limited to, the following:

- An unqualified opinion with wording much the same as in the year prior to the added scrutiny of alternative investments suggested by the *Practice Aid*.
- An unqualified opinion with an "Emphasis of Matter" (EOM) paragraph. The AICPA *Practice Aid* states that "as the inherent *uncertainty* in the estimate increases, as well as the *significance* of the alternative investments to the financial statements, auditors may consider inclusion of an emphasis of matter paragraph in the auditors' report . . . tailored for the specific facts and circumstances." [emphasis added] It gives the following example of an EOM paragraph: "As explained in note X, the financial statements include investments . . . whose fair values have been estimated by management in the absence of readily determinable fair values. Management's estimates are based on information provided by the fund managers or the general partners." An EOM paragraph in the auditor's report sets forth information relating to alternative asset valuation that is contained elsewhere in the financial statements. The purpose is simply to highlight this information and does not diminish an unqualified opinion.
- A "qualified opinion for a scope limitation." This is issued when the auditor decides that the amount and/or quality of audit evidence are inadequate with respect (in this case) to alternative assets. Other scope limitations may be based on more serious matters, such as situations in which "the auditor concludes that the financial statements are materially misstated due to departures from GAAP (Generally Accepted Accounting Principles) related to inadequate disclosure of uncertainties inherent in the investment valuations, failure to apply a valuation method required by GAAP, or valuations that are not supported or are not reasonable."[22]
- A "qualified opinion for a GAAP exception." This is issued if "the potential effect of a GAAP departure is material to the investor entity's financial statements *taken as a whole*." [italics added][23]
- An "adverse opinion." This is a still stronger negative.[24]

There are diverse views among auditors as to how institutions are likely to fare, given the new audit guidance on valuation of alternative assets. Scope limitations based on inadequate audit evidence were

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[20] Note, for example, the statement, "*If* the auditor determines that the nature and extent of auditing procedures should include testing the measurement of the [institution's] investment . . . " [italics added] Ibid., p. 10.
[21] Reviewed by the AICPA.
[22] *Practice Aid*, p. 15.
[23] Again, the greater the prominence of the endowment on the balance sheet, the greater the likelihood that any "GAAP departure" would be material to the financial statements taken as a whole.
[24] Qualified and adverse opinions are described in AU Section 508.

initially considered a good solution from an auditing perspective. From an institution's perspective, however, a scope limitation can have serious consequences with respect to debt covenants and other matters. The *Practice Aid* was issued with these concerns in mind, and devotes several pages to distinctions among an Emphasis of a Matter paragraph, various scope limitations, and other audit outcomes.[25]

What Steps Might Endowments Take to Meet the Challenge of the New AICPA Audit Guidance?

As noted repeatedly in the foregoing discussion, there are no "silver bullets" that will work for all. However, there are some steps that institutions should take, and others that they might consider:

1. **Describe and document the institution's general investment process.** The description and documentation should cover the investment committee, internal staffing, and use of external resources. Key elements might include:
   - Overall portfolio strategy;
   - Investment committee composition in terms of background and experience of its members;
   - Investment staffing in terms of number, education, training, and other strengths;
   - Other investment expertise and research, including external resources such as consultants;
   - Reporting lines within and among the board, the investment committee, the top management of the institution, internal investment staffing, and internal auditors;
   - Agendas;
   - Calendar (timing of specific actions, whether regular or unusual); and
   - Related policy and other documents: the Investment Policy Statement, Investment Committee meeting agendas, meeting materials (e.g., broad research surrounding asset allocation decisions), meeting minutes, calendar and minutes (if any) for internal staff meetings, conflict of interest policy, gift acceptance policy, etc.
2. **Describe and document the institution's specific valuation processes and internal controls with respect to alternative investments, including initial due diligence, ongoing monitoring, and financial reporting.** Appendix 2 of the *Practice Aid* provides *examples,* but consideration of your institution's processes should not be limited to this list, nor should failure to execute any given item(s) on the list be considered an insurmountable obstacle to an unqualified audit opinion. The section on financial reporting, in particular, appears to cover somewhat disparate conditions.[26] In connection with the description of the valuation process and controls, it is helpful to clarify the respective roles of the investment committee, subcommittees (if any), investment staff, CFO, internal auditors, consultants, and

[25] *Practice Aid,* pp. 14-16.

[26] A more complete picture can be gained in an article written by a member of the AICPA task force that issued the *Practice Aid.* This article, written by the CFO of a "small institution," gives specific examples of steps that can be taken in response to the *Practice Aid.* (Dale Larson, "In the Know," *Business Officer,* July/August 2006, published by NACUBO and available on the NACUBO website.) Note that this is from the perspective of someone with "director of finance" responsibilities that include investments. In many endowed institutions, the investment side of the house is independent of the controller side of the house, requiring closer definition of who, exactly, is responsible for monitoring alternative investment valuations.

any other key participants in the investment process. Internal investment and accounting systems are another element that should be documented.[27]

3. **Develop report formats that clearly convey the overall structure, flow, and detail of the above.** Do not be limited by standard formats that have been used by your institution or others. A powerful "visual" or a well-designed table can provide the clarity and assurance that might otherwise be buried in dozens of pages of prose. For example, a table that arranges each fund by type of step taken (calls, visits, etc.), with dates of each action inserted in the matrix, can communicate the broad range of specific steps taken by an investment office (or committee).

4. **Familiarize yourself with fund manager valuation processes and assumptions.** This would apply, as appropriate, to the Investment Committee (not necessarily all members), any relevant subcommittees, investment staff, and internal auditors. Insufficient familiarity means an education is in order. For auditing purposes, responsibility for knowledgeable endowment oversight cannot be outsourced.

5. **Consider requesting an audit team that has not only audit experience with endowments, but also some exposure to investment concepts and the auditing of alternative assets.** It is possible that the major public accounting firms will provide cross-practice expertise between their fund audit practice and their (endowed) institutional audit practice.

6. **Consider some adjustments to governance.** Trustees should appoint to the audit committee at least one member who is very familiar with alternative assets. Large investment committees might benefit from constituting a subcommittee with particular responsibility for alternative assets.

7. **Consider moving your fiscal year end, if possible, to December 31.** While this would enable the endowment to avail itself of fund audits that are consistent with its own fiscal year end, there would obviously be major and perhaps insurmountable difficulties with changing the fiscal year end. Moreover, it would probably be impossible to accomplish in the near term. Nevertheless, some institutions (e.g., foundations) are less burdened with complex administrative structures or operating calendars that make any *future* change in fiscal year end a formidable prospect.

8. **Confer closely with your auditor.** Admittedly this may seem self-evident. However, the explanation and augmentation of an institution's processes with respect to due diligence, monitoring, and financial reporting are matters that benefit from at least several iterations of communication between management and audit team. Likewise the provision of audit evidence and the testing of valuations and assumptions are helped by a shared understanding of the task at hand. For example, one major accounting firm cites among its valuation testing procedures the comparison of valuations with other investments ("especially in the case of investments reported by different [funds] in the same investment vehicle"), third-party estimates, comparisons to public benchmarks, scrutiny of the valuation policies described in the footnotes of a fund's financial statements, and checking for consistent application of these policies in

[27] "Internal investment and business office systems play an integral role in facilitating the monitoring, oversight, and reporting of alternative investments. The ability to track cash investments and distribution in limited partnerships on a periodic basis by individual partnership as well as to compare valuations of similar nonpublic holdings across multiple partnerships can be optimized through efficient information systems. Such systems also *may be* integrated with those used to prepare management and board reports." [italics added] PricewaterhouseCoopers, *Meeting the Challenges of Alternative Investments,* 2004, p. 8.

valuations reported in unaudited quarterly statements.[28] The point is, there are ways to address the valuation task even with the limitations with respect to transparency and timeliness, and institutions and their auditors can gain from working together to deal with these issues.

Conclusion

For endowed institutions, investing in alternative assets is both an opportunity and a challenge. The opportunity is the capacity to achieve superior investment returns over the long term while reducing risk through diversification. The challenge is gaining access to information sufficient to avoid a material misstatement in the financial reporting formats that are used by potential benefactors, debt rating agencies, grant makers, and other funders including the federal government, and state and federal regulatory agencies. Our hope and expectation is that the benefits of investing in these assets will be preserved while the concomitant auditing difficulties are met. Fiscal year 2006 is a particularly demanding year, given the timing of the release of the new audit guidance, but it is to be hoped that the steps and solutions developed this year can be carried through and improved as both institutions and their auditors acquire more experience with this particular challenge.

[28] Ibid., p. 9. In a similar vein, KPMG suggests steps such as comparing the previously reported *un*audited value of of a fund's fiscal year-end to the value reported in the audited statement, and the institution's investment (percentage ownership) at both dates, and investigating any "significant variance." KPMG, *Valuation of Alternative Investments,* presentation to NACUBO Higher Education Accounting Forum, March 27, 2006, pp. 17-19.

EXHIBITS

Exhibit 1

HOW FUND MANAGERS ARE RESPONDING TO AU 9332

Cambridge Associates conducted a hedge fund survey in July and held subsequent interviews with direct hedge fund managers as well as fund-of-funds managers. Fund managers responded to clients' requests in various ways. The range of responses is described below:[1]

- All surveyed funds approached by clients had refused to disclose underlying securities. However, most were willing to work with their clients and auditors to help with the audit process.
- One fund hired a major auditing firm to conduct "agreed upon procedures" as of June 30 each year. Procedures will include testing the valuation of the ten largest positions (long and shorts) and testing a random sample of position chosen by the auditor. The June 30 report will be available to the fund's limited partners.
- A direct fund manager plans to have a mid-year (June 30) valuation in addition to its usual year-end (December 31) audit. While the mid-year valuation will not be a full-scale audit, the valuation will provide additional information to help its investors.
- One fund worked with its auditor to draft a letter addressed to the investor's auditor. A form of this letter, attached below, is designed to help the institution and its auditor to gain comfort in the fund's valuation process and internal risk controls. Other examples of this type of communication have emerged from other funds.
- One hedge fund already has in place a June 30 fiscal year end, matching the year end of most of its institutional investors.
- While most hedge funds already have in place written policies and specific procedures relating to the valuation of securities and other instruments, such as swaps and options, some funds have more detailed documentation of these procedures than other funds.
- A hedge fund-of-funds offered to provide a masked list of underlying securities, that is, a list of holdings with select details, such as market values; however the actual names of the securities would be coded.
- Another hedge fund-of-funds wrote a detailed letter to its investors, describing the fund's valuation policies and procedures, financial reporting controls, and review process regarding the underlying managers' pricing methodologies.

[1] While we did not survey venture capital and private equity managers, these funds generally are more transparent than hedge funds. Venture capital and private equity funds almost always have an advisory committee comprised of limited partners, who meet on a quarterly basis and discuss the valuations of underlying portfolio companies. These funds also typically hold annual meetings for investors and send their investors memos that discuss the underlying portfolio companies in detail. Some auditors have suggested these characteristics provide more support for these funds' valuations and therefore there is less need to seek additional information.

Exhibit 1 (continued)

"XYZ" Capital Management, LLC

Policy - Disclosure of Securities Held

To Investor:

We are aware of the AICPA Audit Interpretation of AU Section 9332, which discusses an auditors requirements when verifying the existence and testing the measurement of investments. As a result, we have received audit requests to provide a detailed listing of the securities in our portfolio, and our specific valuation methodology for each investment.

Although we will assist your auditors in gaining comfort with our investments and their valuation, our policy is to keep our security-level information confidential.

The following factors should provide your auditors with the necessary level of comfort with our investments and their valuation:

1. The initial valuation of the securities in our portfolio is provided directly from [Prime Broker] reporting, which receives the data from outside pricing vendors.

2. We use an outside Fund Administrator, [Insert Name], to compile and review our official books and records. This encompasses a comprehensive, ongoing review of the transactions and balances in our portfolio, as well as an analysis of the valuation methods used by the custodian of the assets, [Prime Broker].

3. Our CFO reconciles our positions and cash balances between the [Prime Broker] custody reporting and our accounting reports on a daily basis; and reconciles the [Prime Broker] valuation of the securities to Bloomberg pricing on a daily basis for reasonableness.

4. As of June 30, 2006, approximately 98% of our current portfolio is comprised of exchange-traded and easily priced equities. The remaining 2% is made up of private investments, which are not accounted for in side pockets.

5. Valuation Policy: Readily marketable securities are valued on the basis of their closing trade prices on their primary exchanges. Illiquid securities and private investments are priced monthly at fair value in consultation with the PM, administrator, outside accountants, outside counsel, and the Board of Directors when appropriate.

6. For the December 31, 2005 audit of "XYZ," our auditors, [Insert Name], did not make any adjustments to the valuation and net asset value we had reposted to investors.

Please feel free to contact us with any further inquiries.

Sincerely,
Chief Financial Officer

Exhibit 2

EARLY CLIENT EXPERIENCES

Because the *Practice Aid* was issued in mid-July, the clients most immediately affected are those with fiscal years ending June 30. In addition, the *Practice Aid* provides significant auditor discretion based on the specific circumstances. Given these two factors, the early approaches used by auditors with respect to guidance from the Practice Aid have been varied. Over the next few weeks and months, we expect auditors and institutions to settle on more uniform approaches. In the meantime, we offer the following observations, with the *caveat* that these processes will evolve over time.

- Thus far, we have not learned of any institution receiving a qualified opinion.

- One institution with a June 30 fiscal year came to an agreement with its external auditors regarding how to handle the mismatched year ends for its hedge funds. The institution provided the following for its audit:

1. The hedge funds' December 31 audited financial statements,
2. The subsequent June 30 unaudited financial statements,
3. Benchmark returns for December 31 through June 30, and
4. Cambridge Associates hedge fund universe median return for December 31 through June 30.

The institution and auditors agreed to an acceptable level of difference between fund returns and benchmark returns. Additional information will be required for funds with returns that fall outside such tolerance levels. While this audit has yet to be completed, this example illustrates a practical framework used by one institution.

- We know of at least two cases in which clients have shifted the valuation of all of their alternative assets from fair market value to cost. In both cases, the clients were health care institutions and further discussions with auditors suggest this may be an issue more specific to these types of institutions. One problem with this approach is that in a declining market environment, using the cost method would overstate the portfolio's value. This approach may also have implications in terms of spending and distributions based on the market values of the pools as well as the financial ratios used by ratings agencies and in operating covenants where the market value of the endowment or total fund is used.

- In several cases involving public universities, auditors have argued that commingled vehicles that are neither separate accounts nor mutual funds should be classified as alternatives, even though those vehicles included only traditional, liquid, long-only securities where both the detailed listing of securities and independent pricing was readily available. While by itself this request should not be a problem, it could be deleterious when combined with approaches requiring alternatives to be carried at cost or to be reported together as a bucket of higher risk assets.

Exhibit 2 (continued)

EARLY CLIENT EXPERIENCES

- Given the early timing of its audit, an institution with a May 31 fiscal year-end faced the challenge of meeting several rounds of auditor requests, as the audit firm itself was as yet uncertain about what evidence might be adequate. Some of the institution's fund managers provided detail of underlying securities while others did not. In the end, the auditor concluded that the evidence was sufficient for the institution to receive an unqualified opinion.

- One large institution that already has in place internal processes and procedures for the management of its investment portfolio, increased the formal documentation of such activity. Among other tasks, this institution visits all of its fund managers on an annual basis, keeps track of which auditor is used by each fund, and has developed organizational or flow charts that show the structure of each fund's broad investment team as well as role of each member. This institution faced minimal challenges from its audit team.

- Another large institution developed a process for evaluating its fund managers for transparency purposes, and this process helped its overall audit process. The institution issues a "report card" that is based on the level of transparency that the fund manager is willing to provide. The institution's private equity managers were more willing than its hedge fund managers to provide transparency. If the institution believed that more transparency was needed, the institution initiated a number of steps, including arranging direct phone conversations between its external auditors and the fund manager.

- Several institutions were able to obtain the detail listing of underlying securities from some of their hedge fund managers under the condition that the external auditors sign letters of confidentiality. These agreements facilitated the overall audit engagements.

Overall, we have found at this early stage that institutions with various investment staffing levels and with various portfolio allocations to alternative assets have managed to provide sufficient documentation on process and valuation to satisfy their respective auditors.

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Exhibit 3

CAMBRIDGE ASSOCIATES' *STANDARD* DUE DILIGENCE PROCEDURES FOR MANAGERS ACTIVELY FOLLOWED BY CA RESEARCH

Overview

Cambridge Associates devotes considerable resources to our manager research and monitoring efforts, employing over 50 research specialists in addition to our extensive investment advisory staff. Over 165 staff members contribute to our performance measurement services. We follow several thousand investment funds. Our formal due diligence processes recognize the different and unique aspects of each asset class.

- We believe that qualitative evaluation of a manager is critical to the management of risk in a portfolio.
- We seek stable firms with a high level of integrity and skill.
- We review quantitative measures of a manager's investment activity in order to gain an understanding of the manager's philosophy and process.
- We consider a manager's potential role in a portfolio. We believe that each manager should be evaluated for its overall risk and return characteristics relative to the risk and return objectives of our client's portfolio. Our goal in advising our clients on constructing a multi-manager portfolio is to avoid duplication and overlap, to understand and manage the risks of the entire asset class subportfolio, to eliminate potentially risky biases, and to avoid unnecessary costs.

The following is a broad description of our standard due diligence process with respect to (1) traditional long-only managers, (2) marketable alternative managers (MALT), such as hedge funds, and (3) non-marketable alternative managers, such as private equity funds. This description is not exhaustive and due diligence for any particular institution depends on the service relationship that the institution has with our firm.

Evaluation and Tracking of Fund Strategy

From our perspective, this is one of the key drivers of ongoing evaluation. Virtually all of our contacts with managers include a component of understanding how performance links with the stated strategy and whether there are any deviations that do not align with either the stated strategy or what the fund manager reports.

Exhibit 3 (continued)

CAMBRIDGE ASSOCIATES' *STANDARD* DUE DILIGENCE PROCEDURES FOR MANAGERS ACTIVELY FOLLOWED BY CA RESEARCH

Quarterly Calls with Fund Managers

For all MALT managers that we actively follow, we conduct quarterly calls to discuss performance, top holdings, market trends, and organizational changes. We also conduct calls for an increasing number of traditional long-only managers and information from the calls is supplemented by significant communications with client consulting teams. Because of the longer time horizon, we do not typically have quarterly calls or visits with non-marketable managers. However, we do send representatives to the annual meetings for non-marketable funds in which we have significant client exposure. We also maintain a database that tracks key information from our contacts with all funds and managers so that information learned by a research or a client team can be easily disseminated to our colleagues across all offices.

Obtain and Review of Interim and Audited Financial Statements

For traditional long-only and marketable alternative funds, we obtain monthly statements that we use to prepare performance reports (flashes). Any unexpected information (unusual performance given markets, etc.) would cause us to follow up with the manager for an explanation. We use quarter-end reports to prepare detailed performance reports which are reviewed by the consulting team with the client, noting and following up on any abnormalities. We do not review audited financials of long-only (traditional) managers. We do review the audited financials of MALT funds.

In the non-marketable space, audited financials and quarterly statements provide the basis of our non-marketable performance reports. Any unusual information would generally trigger a call from one of the client teams or our research staff.

Valuation

As part of our standard due diligence process in evaluating non-marketable funds, we ask about the valuation method the fund uses to value companies and would note if that method seemed unusual to us. For MALT funds, we review the pricing process, price sources and other procedures and controls relative to the calculation of an accurate net asset value (NAV). We do not ask traditional long-only managers about their valuation methodologies. In all cases we rely on information from fund managers rather than verify valuations.

Exhibit 3 (continued)

CAMBRIDGE ASSOCIATES' *STANDARD* DUE DILIGENCE PROCEDURES FOR MANAGERS ACTIVELY FOLLOWED BY CA RESEARCH

Monthly, Quarterly Annual Investment Reports

For clients who subscribe to our performance reports, we provide three broad reporting options: total portfolio, marketable alternative, and non-marketable alternative reports.

The total portfolio reports present information on the performance and market values of all of the components in the portfolio in both the monthly flash and detailed quarterly report formats. In addition, the detailed quarterly report includes information about asset allocation versus policies and detailed portfolio analysis and characteristics for traditional long-only managers.

Marketable alternative performance reports provide information about performance and market values of all of the marketable alternative funds. In addition, the detailed quarterly report includes breakdowns of the allocations to various investment strategies and a written summary of what we learned in quarterly calls with the funds.

The non-marketable performance reports include performance, committed capital, and NAV for the non-marketable funds in the portfolio. In addition, for private equity and venture capital funds, the reports track exposures to underlying companies by stage, geography, and industry.

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