CAMBRIDGE ASSOCIATES LLC

ENDOWMENTS AND ALTERNATIVE INVESTMENTS: PREPARING FOR THE NEXT AUDIT

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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.

ENDOWMENTS AND ALTERNATIVE INVESTMENTS: PREPARING FOR THE NEXT AUDIT

A Working Paper

I. Key Elements in an Audit of Alternative Investments

Since the July 2006 issuance of the American Institute of Certified Public Accountants' (AICPA) detailed new guidance on the auditing of alternative assets held in endowment portfolios,[1] investment offices and investment committees have been adjusting to their auditors' heightened expectations regarding the role of institutions in reporting the valuation of these endowment assets. The main focus has been on the institutions' ***initial due diligence***, ***ongoing monitoring***, and ***reporting*** on fund valuations and the ***documentation*** of this review.[2] These items are assessed by auditors within the context of the ***overall investment process*** (decision-making and control)[3] and the ***adequacy of investment staffing*** (including the investment committee) to handle these responsibilities. Each of these topics presents a challenge to investment professionals whose attention has dwelt mainly upon such issues as portfolio risk and diversification, performance reporting, and asset manager structure and selection.

While auditors are not uninterested in portfolio risk, the particular risk they are evaluating is the risk of material misstatement on the financial statements of the institution. Thus, whether a given valuation question, involving a given dollar amount, is considered extremely problematic or is considered immaterial is not determined only by the valuation-related factors highlighted above. It is also determined by the size and role of the endowment assets within the overall financial structure of the institution, including endowment support of operations and such other assets as physical plant and non-endowment financial assets.

Moreover, different auditing teams dealing with what appears to be the same issue can and do reach different conclusions. Beyond their assessments of the six topics highlighted above and the role of the endowment within the overall financial statements, they may be guided by differing firm-wide policies, they may have more or less experience with alternative investments, or they may be more or less risk-averse (or more or less inclined to exercise discretion). In their 2006 audits, institutions have reported a very wide range of inquiries and suggestions from auditors.

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[1] AICPA, *Alternative Investments – Audit Considerations: A Practice Aid for Auditors,* July 2006.

[2] While this working paper addresses valuation (the "valuation assertion"), auditors also seek to confirm the "existence assertion" i.e., that the alternative investments exist. Many of the activities associated with confirming valuations would cover, by their nature, the existence assertion; however, auditors particularly emphasize checking the institution's percentage interest in a given fund, preferably reported in an audited financial statement but also typically acceptable in unaudited quarterly and semiannual statements.

[3] "Control" consists of measures to detect any lapses in the process (e.g., the due diligence process) in place at the institution. An example of a key control is an investment policy, discussed and formally adopted by the board's investment committee, and either carefully adhered to or departed from only by formal exception that is documented in the meeting minutes.

II. 2007 May Be More Difficult Than 2006

Most agree that 2007 will be an even tougher audit year than 2006, for several reasons. First, because of the July 2006 timing of the AICPA *Practice Aid,* many audit teams as well as their clients were caught mid-stream. Consequently, particularly with respect to the question of documentation, auditors were inclined to be less demanding toward clients. However, their expectation is that by the time of the 2007 audit, documentation should be in place or at least demonstrably improved.

Second, depending upon the pace of implementation of alternative asset programs and the relative performance of various asset classes within an endowment, the percentage "threshold" for stiffer audit requirements may be passed. For example, a 2006 portfolio with a 20% allocation to alternative assets might have that allocation grow to over 25% by the end of fiscal year 2007, triggering closer scrutiny if the audit firm's policy is to apply tighter guidelines for portfolios exceeding a 25% threshold.

Third, further new guidelines will take effect. Statement on Auditing Standard (SAS) 112 applies to audits of entities with fiscal year ends of December 31, 2006, and thereafter. This new guidance will reduce auditor discretion when reporting on internal controls, and will also require broader circulation of audit findings and suggestions. For example, previously an audit team might informally suggest tightening of certain procedures, perhaps not even putting their suggestions in writing. Hereafter, they will be required not only to put their observations in writing (typically in the "management letter"),[4] but also to give this report to the audit committee of the board. In turn, the audit committee would be expected to report the internal control suggestions to the full board as well as (one hopes) to the investment committee. SAS 112 permits less auditor discretion in judging whether a control lapse is a "significant deficiency" or a "material weakness"[5] and is likely to lower the threshold for reporting control deficiencies. Thus, an audit team might be required to be less forgiving as well as less private when there are lapses. If the audit team concludes that there is a material weakness in internal controls with respect to reporting on alternative investments, then the institution may risk receiving a qualified opinion such as a "scope limitation" referencing its alternative assets, depending on the circumstances of the particular audit. Finally, aside from new audit guidance, management letters are now more often requested by foundations and government funding sources as well as occasionally by major donors and bond rating agencies.[6]

An additional new guideline is due to take effect for the fiscal years beginning after November 15, 2007. Financial Accounting Standard (FAS) 157 addresses the "fair value" of alternative assets and is thought to pose particular challenges for private equity and venture capital funds.[7] Valuation on the basis of

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[4] A management letter is addressed to "management" (including the audit committee of the board and/or the trustees). Containing suggestions for improvements in process, controls, documentation, and any other matters that may have come to the audit team's attention during the course of the audit, the letter is issued annually around the time of the opinion letter at the conclusion of the audit.

[5] These terms replace the "reportable condition" designation which was often used in the past.

[6] Frank Kurre, "Next Practices: Enhancing Fiscal Transparency Through Public Disclosure of Management Letters," *ForwardThinking,* Grant Thornton LLP, 2006, Issue No. 8.

[7] FAS 157 defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants *at the measurement date."* (italics added)

cost or the latest financing round will no longer be sufficient, unless it can be demonstrated that such valuation comes closest to meeting the new fair valuation standard (e.g., a sufficiently short period of time has elapsed since the latest financing round). In many cases, further valuation steps will be expected, including comparable company transactions, performance multiples, and/or other approaches, to determine the "exit value" of fund components as of the reporting date. For marketable alternative investments ("hedge funds") as well as private equity and venture capital funds, FAS 157 will require that the funds' assets and liabilities (e.g., derivatives, short sales) be classified in terms of the "observability" of valuation inputs, discussed later in this report.

Fourth, there is the issue of unrelated business income tax (UBIT), which recently has begun to command more attention.[8] UBIT liabilities are generated primarily but not exclusively by the use of leverage in alternative investments. Because state income tax liabilities have become more important recently, it is useful to seek legal counsel on applicable law in any given state.[9]

Finally, liquidity issues at both the portfolio company level and the fund level will receive more scrutiny by auditors. In addition, an institution's alternative investments may be assessed by auditors within the context of the liquidity demands of the institution as a whole. For example, auditors might ask whether the alternative investments at a given institution provide sufficient liquidity to meet institutional spending needs. These concerns apply particularly to venture capital and private equity investments and hedge funds with lock-ups, significant side pockets, or other liquidity restrictions.

III. Steps To Consider

1. Initial Due Diligence

The due diligence process involves the application of experienced judgment and the collection of a considerable amount of information, data, and formal documents such as audited financials and the offering or private placement memorandum. These must be filed and accessible, for confirmation purposes. Meetings, calls, and background checks are noted. In addition, documents relating to the investment decision should be retained for each fund: meeting minutes, discussion materials, expected role of the fund within the broader endowment portfolio, etc. In the context of recent AICPA guidance, information describing the fund's valuation methodology(ies) will be particularly relevant.

Cambridge Associates monitors hedge funds ranging from long-standing funds to more recent entrants. The rigorous screening process filters a universe of thousands down to a field of several hundred. The process includes repeated discussions with managers over some period of time prior to making or

[8] A recent webcast by the National Association of College and University Business Officers (NACUBO) highlighted tax considerations in alternative investments. NACUBO, *The Operational Commitment to Alternative Investments,* March 27, 2007.

[9] Recently the U.S. Senate Finance Committee has been discussing whether to repeal the UBIT exemption for tax-exempt investors in off-shore funds. The Managed Funds Association is making efforts to discourage such initiatives.

recommending an investment decision, to confirm consistency of approach and strategy as well as sufficient transparency into a given fund's processes and organization; site visits; background checks; and other steps. The due diligence process covers around a dozen risk factors, including security risk, portfolio risk, and organizational risk. All of these relate to the "valuation risk" that auditors are now seeking to identify. Quite obviously, were Cambridge Associates to have any serious reservations about a fund's valuations, then it would consider the fund's performance data to be suspect and would not permit the fund to pass its rigorous due diligence process. Hence there is an element of artificiality in breaking out "valuation risk" separately. Nevertheless, one can attempt to focus on this area of risk by examining a fund's pricing policy, profiling the valuation sources, evaluating the profile, reviewing the fund's audited financials and other communications, and determining whether there are supporting documents such as an "Agreed Upon Procedures" (AUP) report (to be discussed later), a third-party verification source,[10] or other "audit evidence."

For venture capital and private equity investments, including hard assets and funds-of-funds, Cambridge Associates' initial due diligence process parallels and extends the hedge fund initial due diligence process. The illiquid nature of the asset class requires substantial direct contact with the fund manager, the underlying portfolio companies, and advisors. Each year, over 2,000 funds are screened and over 1,000 meetings conducted with fund managers. The inherent inefficiency (desirable for investment reasons) and nature of these investments demand a considerable amount of focused primary research. Both broad market coverage and network are important to the firm's informed view on manager team quality, strategy, and other important qualitative factors.

2. Ongoing Monitoring (Ongoing Due Diligence)

To enable auditors to review the ongoing monitoring of the institution's alternative investments, it is helpful to present one or more summaries of the information available for each fund invested in. The purpose is to provide audit evidence in the form of the specific factors that are weighed for each fund. The document might summarize the following items for each hedge fund:

Overall Summary

- Fund name
- Investment strategy
- Fiscal year end market value of institution's share of fund
- Percent of the institution's total assets and/or net assets
- Valuation policy
- (Possibly: valuation risk class)[11]

[10] Only 10% of hedge funds responding to a recent survey reported using a third party—other than an external administrator—to calculate net asset value (NAV). Sixty-one percent use an external administrator for this purpose. Barry Kolatch and Lynn Connolly, *Precautions that Pay Off: Risk Management and Valuation Practices in the Global Hedge Fund Industry,* Deloitte Research, January 2007, pp. 12-13.

[11] One audit firm suggests that auditors might classify funds in terms of valuation risk levels—"low," "moderate," and "high." Although this involves a systematic review, such an approach to measurement cannot be readily quantifiable. The firm states that this approach "involves considerable judgment by the auditor." Michele Godvin, Tim Grady, Mike Greenstein, and Leah Ann Leahy, *Auditing Alternative Investments: A Practical Guide for Investor Entities, Investee Fund Managers and Auditors,* PricewaterhouseCoopers, April 2007, pp. 18-22.

- (Possibly: asset distribution in terms of "observability" of "valuation inputs")[12]
- Audit firm
- Fund administrator
- Fund prime broker(s)

Ongoing due diligence

- Meetings and calls
- Business risk review
- Valuation/pricing policy
- Profile of valuation source (percent of portfolio priced using each pricing source)
- Side pockets as percent of portfolio
- Audited financials
- Administrator statements
- Other fund communications

In the case of private equity and venture capital funds, the document might summarize for each fund:

Overall summary

- Fund name
- Investment strategy
- Fiscal year end market value of institution's share of fund
- Percent of total assets and/or net assets
- Valuation policy
- Audit firm

Ongoing due diligence

- Annual meetings
- Other meetings and calls
- Changes (if any) in valuation policy
- Audited financials
- Quarterly statements
- Other fund communications

All the above should be linked to supporting documentation as necessary. The point is to provide strong evidence of a systematic process. Further, perhaps obviously, the format can be used as the guide to a filing system, whether those files are in hard copy or in an electronic database.[13] Indeed, in many situations, "documentation" residing in electronic databases exceeds that which is readily available in paper copy.

[12] This typology is required by FAS 157. Funds will have to report, in their audited financials, the distribution of their portfolio among three levels of observability. Financial Accounting Standards Board's (FASB) intent is to compel funds to provide more information to support "fair value." This three-level typology is required for fiscal years beginning after November 15, 2007, and presumably would be available to hedge fund investors when the December 31, 2008, financial statements are released.

[13] Note that software is now available that permits not only word and data entry, but also the scanning of lengthy documents.

Cambridge Associates provides ongoing monitoring of funds held by investing institutions that have engaged our firm for certain specific services relating to specific funds. These services typically include the "ongoing monitoring" steps listed above.

3. Financial Reporting

Financial reporting includes such standard items as a formal investment policy and regular reports on all the funds in which the institution is an investor. These reports include performance reports and audited financial statements for each of the funds. Institutions are asked to disclose in their financial statements the expected future capital payments (capital calls) for private equity and venture capital investments. The AICPA *Practice Aid* also suggests that auditors request from the institution "an assessment of the risk of material misstatement of the financial statements related to the valuation of alternative investments." A carefully documented review of the key factors pertinent to valuation is strong evidence that the institution has not overlooked important features. Further, the institution should provide a calculation of alternative investments as a percent of endowment, as a percent of total net assets, and as a percent of total assets. Documents such as these provide evidence of the degree of risk of material misstatement. The institution should present to the audit team a formal assessment based at least on these factors and on any other evidence that the institution deems relevant.

4. Documentation: Why So Important?

Obviously, documentation is implicit in all of the procedures described above. Many institutional investors have understandably complained about the extraordinary additional and unexpected burden upon them to provide this level of detailed documentation. Often they have wondered why auditors focus so intently on this part of the investment process. There are two, related reasons, both self-evident once they are described:

- *Without documentation, auditors have little to audit.* It is better to provide auditors with something to audit—i.e., evidence of the institution's investment process—than to have auditors waste their time pursuing approaches that may not be adequately targeted at the important factors involved in investment decisions.

- *Documentation is necessary evidence of appropriate investment oversight.* Institutions without adequate documentation are likely to be judged to be insufficiently serious about oversight. Ultimately, the investment committee and the trustees want to demonstrate that they have considered the important factors when choosing to invest in a given fund, or choosing to continue or to exit a fund. While an institution can "outsource" most aspects of investing, it can never outsource its oversight, which is its fiduciary responsibility.

Ideally, every step of an institution's dealings with fund managers would be documented. However, until the issuance of the *Practice Aid,* many of the control steps and reviews were only partially documented at most institutions. In terms of the "Internal Control Maturity Framework" advanced by one of the major

public accounting firms, many endowments have "informal" systems: "control activities are designed and in place, but are not adequately documented."[14] A further important observation is that not all documentation is in written paper form. There may be considerable documentation in electronic files and databases and online tracking that is not yet available in regular "hard copy."

A very recent report by a public accounting firm lists the following "recommended documentation practices:"[15]

- Written due diligence memos and checklists
- Written minutes of meetings at which decisions were made on selection and evaluation of fund managers
- Written documentation of visits or discussions
- Written investment policy approved by the investment committee
- Written review of audited fund financial statements, including reconciliations, roll-forwards if necessary, and returns compared to benchmarks
- Written review of valuations, with memo documenting acceptance by the investment office

Obviously, these requirements are meant to encourage close oversight of the investments and to remind endowments that while much of the initial and ongoing due diligence can be "outsourced"—and indeed generally is except in the case of very large and specialized investment offices—the oversight and fiduciary responsibility cannot be shed by the institution. Documentation of the steps noted above would be evidence of necessary oversight steps.

Numerous auditors have commented that it is *not* their expectation that each institution should call and visit each fund that it is invested in. And of course the fund managers express dismay at such a prospect. Thus, as a practical matter, it becomes necessary for many institutions to engage either a consultant and/or a fund of funds to provide monitoring.[16]

[14] John A. Mattie, Lee Ann C. Leahy, Sean P. Riley, and Dale L. Cassidy, *SAS 112 Internal Controls Readiness: A PwC Perspective,* 2006, p. 2. This framework gives five stages of "maturity:" "unreliable," "informal," "standardized," "monitored," and "optimized."

[15] John A. Mattie, Michael S. Greenstein, and Lee Ann Leahy, *Institutional Oversight: Managing the Challenges of Alternative Investments in the Higher Education Environment,* PricewaterhouseCoopers, 2007, p. 17.

[16] If consultants are thus engaged, it should be with a clear understanding that "ongoing due diligence" will be supplied; this service is *not* typically a follow-on from the initial due diligence that is conducted prior to investing in a given fund, but is often a separate service or part of a broader advisory service. Among other things, the AICPA *Practice Aid* has made it necessary to determine precisely what services are, or are not, covered by the consulting agreement. In this context, the cost of additional service (e.g., ongoing due diligence) should be weighed against the cost of having to hire staff to accomplish this in-house at a time when the compensation cost of sufficiently experienced alternative investment staff is soaring.

5. Overall Investment Process

Institutions can provide considerable assistance to their auditors by systematically describing their investment process. A starting point is a process chart such as the example depicted in the accompanying exhibit on page 15. This particular illustration is entirely generic, and would be adjusted, as appropriate, for any given institution. Moreover, the chart is broadly keyed to the three areas of inquiry by auditors (initial due diligence, ongoing monitoring, and financial reporting), and shows managers that are "discarded" in the investment decision-making process, as well as those that pass muster—evidence, in itself, that the investment committee is no rubber stamp. The section on ongoing review differs widely from one institution to another. One must be cautious, both here and elsewhere, to describe only what one expects to do: *be careful not to depict or describe steps that are not always taken.* Any audit evidence that is provided should be robust and consist of steps that are faithfully executed. As noted earlier, SAS 112 will increase auditors' focus on this type of internal control.

6. Investment Resources: The Investment Committee and the Investment Staff

Whether explicitly or implicitly, auditors will form judgments as to the adequacy of the investment support behind the alternative investment portfolio. Several factors are important:

- *The adequacy of staffing, in terms of numbers and kinds of individuals*, to provide "comfort" to auditors that investment decisions are well made and the funds well monitored for valuation purposes. Thus, for example, a financial/investment office staffed by a single individual would have to demonstrate a robust working relationship involving a well-engaged investment committee and/or the outsourcing of a portion of the investment function whether through use of an investment consultant or fund of funds.

- *The familiarity of investment office staff (or members of the investment committee) with valuation approaches* and relative levels of "risk" of misstated valuations in various funds.[17] At the very least, investment staff should be familiar with broad valuation typologies and which ones are most prominent in their portfolios.

- *Internal communication between investment staff and the controller's staff* who work with the external audit team. In some institutions, the audit process is handled by the controller's function, with only occasional (or many) questions selectively directed to the investment staff. At institutions in which the controller's function is entirely separate from the investment office, it is important that the investment staff be sufficiently involved in the audit process for alternative assets and that there be direct communication with the external auditors as well as working through the controller's office.

[17] See footnote 11. FAS 159 will require funds to provide further information relevant to valuation risk levels.

IV. Results of the 2006 Audits

For most endowments, 2006 was a difficult audit year. There was little time to conform to the AICPA *Practice Aid,* which (in effect) forced institutional investors and institutional auditors to develop shared solutions to an unfamiliar challenge. Most investment professionals are unfamiliar with audit standards and documentation requirements, and most institutional auditors are unfamiliar with investments that lack transparency or are "complex." Despite the considerable hurdles, and no doubt by dint of extraordinary effort, nearly all endowed institutions received an unqualified opinion.[18] In a survey of endowments that Cambridge Associates works with, all but four or five received a simple unqualified opinion. A handful received an unqualified opinion with an "Emphasis of Matter" paragraph highlighting a financial statement disclosure that the valuation of the alternative investments was based on reports received from fund managers (which valuation basis was the common practice until the issuance of the *Practice Aid*).

The endowments that had the most difficulty tended to be those with less documentation, or with documentation not readily accessible for audit purposes. In some cases, the external auditors set up files, spreadsheets, and loose-leaf binders containing essential documents for each fund. In these cases, the auditors would expect the institutions to do these steps for themselves, or to update what was done for them last year—at the very least. Institutions in which the endowment plays a very important role in the operating budget or in which a large percentage of the endowment[19] was invested in alternative investments, generally received closer scrutiny. Internal communications within the institution were problematic for some. For example, if the auditors speak mainly or exclusively to the controller's office, they might find it harder to understand the key *investment* factors. In some cases in which investment officers appeared not to wish to deal with audit questions, insufficient "comfort" was provided to auditors who questioned seemingly risky funds (in most cases, "risky" only because non-transparency made them harder to value for audit purposes). In other cases, individuals from the investment office or investment committee had difficulty demonstrating to the auditor's satisfaction that they were exercising sufficient fiduciary oversight. Some complained that it was difficult to demonstrate this to auditors unfamiliar with investment particulars.

Some auditors, even (occasionally) within the same firm, provided advice that was at variance with advice provided to other institutions. In several cases, there were issues surrounding classification of certain long-only, completely transparent and completely liquid funds as "alternative" investments, thereby inflating the institutions' exposure to alternative investments in a manner inconsistent with actual valuation risk. Some institutions "pushed back" harder than others—for example, by contesting the classifications. Despite such cases, there was a genuine desire on the part of auditors to work with endowments in arriving at solutions that both parties could live with.

[18] We have learned of only one case in which there was a qualified opinion, specifically a scope limitation attributable to alternative assets. In this case, as reported by Moody's, over 70% of the endowment was invested in alternative assets, entirely in funds-of-funds that did not provide sufficient transparency. Nevertheless, Moody's upgraded the bonds issued by this institution.

[19] Or a large percentage of total net assets or total assets.

In 2006, the central problem to be solved was the non-transparency of marketable alternative investments (hedge funds). The partial or total absence of a "readily determinable" value was addressed by the following means:

- **Audited financial statements with a fiscal year end identical to the institution's.** Because most funds have December 31 fiscal years, while endowed institutions tend to have fiscal years at June 30, this most desirable form of "audit evidence" was not available to most institutions. (Foundations with December 31 fiscal year ends are a notable exception.) Even institutions with non-coincident fiscal years can apply a "roll-forward" methodology to state a June 30 valuation that would then be subjected to reasonableness tests of various kinds; e.g., performance benchmarks.

- **Partial portfolio disclosures.** Methods that have been used to the satisfaction of particular auditors include: top ten (or more) holdings; disclosure by means of phone conversations or one-time (undocumented) viewings; and percentage portfolio composition in terms of pricing sources, types of instruments, regional focus, and/or market capitalization.

- **Agreed Upon Procedures.** These are tests of valuation process and controls at an investment fund, conducted by an external auditor, perhaps the same firm that audits the fund at the end of its fiscal year. An AUP that is conducted at June 30 provides some evidence of whether the fund is adhering to its valuation policies and procedures. Funds may conduct AUPs and simply add the extra expense to the audit fees that are typically charged to their investors. However, some funds might price an AUP independently for only those investors who request it. Either way, it requires a signed agreement, between the fund and the institutional investor, that certain procedures will be applied and the test results reported. Because the audit firm does not issue an opinion on the results of those tests and procedures, the AUP does not provide a level of "comfort" equivalent to an audit.

- **Third-party verification of valuations.** Fund managers may hire a firm that specializes in valuations to review their valuations. This is thought to be a fairly robust form of "audit evidence" because an independent third party will ostensibly exercise impartial judgment, much as debt rating agencies provide evaluations for institutions issuing debt. While many hedge funds use independent third parties to provide pricing for parts of their portfolios, only 10% use them for calculation of the fund's NAV, as noted earlier. Most funds simply use their external administrators for NAV calculations, which approach is less independent (however, superior to using internal back office staff to calculate NAV).[20] Some private equity funds have also considered or adopted third-party verification, particularly for conformance with FAS 157.

- **SAS 70 reports.** Frequently requested by institutional auditors, these are formal reviews of internal controls and procedures, with an auditor's opinion. However, these are rarely available from fund managers, simply because funds do not generally undergo these reviews, to date.

[20] Auditors prefer that reports from a fund's external administrator be conveyed directly to the investing institution, rather than to the fund. Institutions not receiving a fund's periodic statements directly from the external administrator, should consider requesting this direct communication.

Of course, as noted in our September 2006 report, *Auditing Alternative Investments: An Endowment Perspective,* there does not exist an audit solution that can be applied in all cases. That is because each audit is couched in the circumstances of each particular institution, and subject to the judgment of the particular audit team exercised under particular circumstances.

Nevertheless, lest each year's audit become an original creation subject to ever-changing approaches (as was the case in 2006 and even 2005, for some institutions), one must hope for the development of new "standard" approaches to replace the ones no longer acceptable. For example, it is possible that AUPs could become one such standard approach, were enough funds to adopt them and were auditors to judge that they offer adequate "comfort" in given circumstances.[21] Independent verification could be another standard, although the majority of funds are likely to resist such a standard. Alternatively, it is possible that the more detailed formal reporting of fund valuations required by FAS 157—including a mandatory breakdown of assets and liabilities by the degree to which their values can be observed—will contribute to the establishment of a new standard for endowment audits.

V. What About Non-Marketable Alternative Investments?

We received very few client reports of difficulties with the audit of non-marketable assets such as private equity and venture capital funds, other than complaints about lack of timeliness in receipt of financial statements and K-1 reports. Because these portfolios are generally fully disclosed, and because of the widespread convention of carrying the investments at cost or latest financing round, there was little controversy surrounding the valuation of non-marketable assets during the 2006 audit.

That has begun to change. With the issuance of earlier AICPA guidance and FAS 157, to take effect in late 2007 (i.e., after the fiscal year ends of many institutions), the valuation of non-marketable funds will change. No longer will portfolio assets more or less automatically be valued at cost at time of acquisition ("entry price") or at latest financing round, but instead at a figure that represents the "exit price" were a given asset sold at the fund's fiscal year end.[22]

Funds are now wrestling with various approaches to this new valuation method, which will inevitably require fund managers to use judgment in lieu of the previous method. The intent of certain industry groups, such as the Private Equity Industry Guidelines Group (PEIGG), is to work toward a "framework" in which different managers will use a common methodology. "While the managers' judgment

[21] Because funds would not want to conduct more than one AUP annually, it is likely that most AUPs would cluster around June 30. Institutions without a June 30 fiscal year would then find an AUP less helpful. (Obviously those with December 31 fiscal years would need few if any AUPs because their fiscal years would be coincident with the fiscal years of most funds.)

[22] Particularly for venture capital portfolio companies, the "exit price" could certainly be determined to be equivalent to cost or latest financing round, but this would have to be demonstrated. "Fair value" does not exclude this valuation methodology, but requires—if used—that it be the best reflection of exit price.

will result in different, but supportable views on valuation, using a common methodology should *narrow the range of these results* (italics added)."[23]

For those venture capital and private equity funds that have not already begun to adopt FAS 157 valuation requirements, the new valuation methodology will presumably be disclosed in their 2007 or 2008 fiscal year end financial statements (usually at December 31). Until the new valuation methodologies are in place, the audits of these funds by their own auditors can be expected to delay many funds' audited financial statements. It may be two years—two more institutional audit cycles—before timeliness can be improved.

Nevertheless, for many institutions, non-marketable investments are a smaller percentage of the endowment than are marketable alternative investments. Although there are notable exceptions, the overall balance sheet exposure tends to be less, strictly in terms of percentage allocations. Thus valuation questions in this part of the endowment may in many cases be deemed less material. However, it is important that the institution demonstrate adequate knowledge of the liquidity and cash flow implications of investments in this type of asset—i.e., sufficient planning for lock-up periods, capital calls, and other features of this kind of investing that can affect the institution's operations.

Some non-marketable fund managers have contracted with independent valuation specialists to verify their asset valuations.[24] It is safe to say that most funds are unenthusiastic about taking this step. Some have argued that there is a spectrum of controls over valuation, ranging from adoption of corporate governance standards, to utilization of independent valuation specialists, to (unlikely and undesirable) government regulation—and that improving governance is a better approach.

VI. Conclusion: The Shifting Ground

Clearly, events surrounding the auditing of alternative investments are moving rapidly. Three separate parties are engaged in a complex process of arriving at a solution that all three can live with: endowed institutions, fund managers, and the audit firms that work with the institutions. Each of these parties has a distinct perspective and incentive structure,[25] and yet all agree that it serves no one well to become bogged down in misunderstandings and unnecessary effort, or to exit alternative investments to avoid administrative "hassle." The challenge is to find a solution that can soon become "routine" for all parties in producing agreement on the valuation of any given alternative investment.

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[23] David L. Larsen, "Valuing Assets Held by Private Equity Funds—New Guidance from PEIGG," *Business Valuation Update,* March 2007, Vol. 13, No. 3, p. 2. Larsen is a PEIGG Board member and technical advisor to PEIGG's Valuation Subcommittee.

[24] Such independent valuation specialists include Pluris Valuation Advisors LLC, Duff & Phelps, Houlihan Lokey Howard & Zukin, and Cogent Valuation.

[25] One reason that auditors consider it so important to test valuations of alternative investments is that fund managers' compensation structures create what appear to be (as noted in the audit literature) adverse reporting incentives when performance falters. And as more institutions also adopt performance-based incentives for investment office staff, auditors' risk aversion favors more testing.

The endowed institutions want to be able to preserve the obvious investment performance and risk mitigation benefits that an endowment portfolio obtains by diversifying away from the public markets. They generally have carefully weighed the advantages and disadvantages of investing in alternative assets, and have found that the former greatly outweigh the latter when the investments are undertaken with adequate due diligence and adequate thought about the role of the endowment in the overall financial structure and operations of the institution. They generally have adhered to a rigorous investment process involving both the investment committee and investment staff, often supported by consultants who are experts in alternative investments.

However, many institutions have not documented their process, decisions, and oversight as fully as is now expected by auditors. The primary task for endowments is documentation, which most have discovered to be no small task. Some institutions are also re-visiting the issue of overall investment resources: are they sufficient, given the changed circumstances? Should the investment office be expanded? How costly would it be to attract and retain the necessary expertise in alternative investments? Would their offices become subject to disruptive turnover in investment staff as alternative investment staff are lured away to other institutions or to the funds themselves? Alternatively, should the role of a consultant be expanded to provide the higher investment resource requirements? Should the investment committee be changed or become more involved, perhaps adding trustees who are fund managers to provide more knowledgeable oversight, while also avoiding conflicts of interest? Should there be a separate subcommittee of the investment committee to address alternative investment decisions? The questions are numerous.

Meanwhile, the fund managers would like to avoid having to take actions that disrupt their fund management and performance. They do not want to disclose, nor should their investors want them to disclose, competitive information critical to their performance.[26] They do not want their principal decision-makers to spend time talking with investors when that time is better spent producing good performance for those investors. Some institutional investors have interpreted the *Practice Aid* to require that they phone their fund managers quarterly; clearly were all institutional investors to adopt this practice, they would soon find themselves talking with new employees hired by the funds for the sole purpose of dealing with hundreds (perhaps thousands) of additional, duplicative phone calls. This arguably would defeat the purpose of those calls (or visits) which is: the transmission of meaningful information. It is also the case that some funds will transmit confidential information to trusted investment consultants, for the purpose of satisfying consultant scrutiny, but not for the purpose of disclosure to anyone else. All parties to the current conversation about valuation—the endowments, the fund managers, and the auditors—would be badly served were this information channel to be cut off (in effect) by certain kinds of audit documentation demands.[27]

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[26] Audit firms may advise their field auditors to be mindful of this. For example, one instruction reads as follows: "Information that creditors and counterparties should seek to obtain from a private pool includes both quantitative and qualitative indicators of a private pool's NAV, performance, market and credit risk exposure, and liquidity. The level of detail expected should respect the *legitimate interest of the private pool in protecting its proprietary trading strategies."* Michele Godvin, Tim Grady, Mike Greenstein, and Leah Ann Leahy, *Auditing Alternative Investments: A Practical Guide for Investor Entities, Investee Fund Managers and Auditors,* PricewaterhouseCoopers, April 2007, p. ii.

[27] It is worth repeating that certain kinds of documentation may reside in electronic databases and not necessarily in written paper copy.

On the other hand, it is certainly the case that fund managers can do more to provide audit "comfort" on their valuations. They can provide more information on their valuation methodology and processes. Those not providing full disclosure can provide meaningful partial portfolio disclosures. They can develop AUPs sufficient to help meet the concerns of many institutional auditors, or they can use external administrators or independent valuation agents to calculate NAV.[28] Perhaps they can work to provide more timely audited financials. Most fund managers are now aware of the extraordinary new demands that have been placed on their institutional investors, and are seeking ways to help meet them. Moreover, many of the new audit demands (FAS 157, SAS 112) affect the funds directly and force many to reassess their procedures and methodologies and to produce more detailed financials.

Finally, the audit industry is also seeking pragmatic ways to meet the Practice Aid guidelines. It is attempting to educate its institutional field auditors (nonprofit practice auditors) on investments, and particularly alternative investments. At the national practice level, there are efforts to develop firm-wide guidelines that nevertheless allow individual audit teams to exercise the judgment necessary to audit "on the ground." Specific audit recommendations have been developed by some firms to guide their clients in preparing for audits of alternative investments. Some efforts have been made to show that alternative investments are not accurately characterized as "risky" in the popular, commonplace understanding of that word.

Of course, institutional auditors want it clearly understood that responsibility for valuations lies not with them but with "management" (the institution). They want to be assured that management is up to the task: that there is a clear investment process that is routinely followed, adequate due diligence and discussion before investment decisions are made, and sufficient ongoing due diligence. The auditors' view is that they cannot be assured in situations in which there is inadequate documentation to demonstrate that management is up to the task. Yet, for practical reasons, auditors dislike having to issue a qualified opinion (such as a scope limitation) almost as much as institutions dislike receiving such an opinion.

There is plenty of ground for all three parties to meet and come to agreement. Each party has moved its position over the past year, and for all the apparent turbulence of the 2006 and upcoming 2007 and 2008 audits, progress is clearly being made toward a resolution that can serve all parties well in the coming years.

[28] Hedge funds can also adjust their governance or have a valuation committee be responsible for reviewing their valuations, as suggested in *Principles for the Valuation of Hedge Fund Portfolios,* Technical Committee of the International Organization of Securities Commissions, March 2007.

INVESTMENT PROCESS DESCRIPTION: A SAMPLE PROCESS CHART