



## NOT-FOR-PROFIT HEALTHCARE Auditing Alternative Investments

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- The American Institute of Certified Public Accountants (AICPA) recently issued new audit guidelines for investments where a “readily determinable fair value does not exist”. The new guidelines address alternative investments (hedge funds, private equity and real assets) and commingled funds for traditional asset classes, and have complicated the annual audit process for many not-for-profit healthcare providers.
- Confusion has resulted from the new AICPA guidelines due to differing concepts of risk between auditors and investors. From an auditor perspective, risk focuses on material misstatement of the institution’s financial statements. From an investor perspective, risk usually focuses on missing investment return goals, volatility of returns and simply losing money. In planning for the annual audit, healthcare management will benefit from taking the auditor’s perspective of investment risk. Demonstrating an understanding of the investment portfolio strategy, documenting the investment manager selection and monitoring processes and concentrating on complex and illiquid investments may expedite upcoming audits. Much of the evidence gathering can be done prior to the auditor’s on site work.
- A great deal of distress was caused by the AICPA’s edict that “management is responsible for the valuation of alternative investment amounts ... *This responsibility cannot, under any circumstances, be outsourced or assigned to a party outside of the investor entity’s management.*” In most cases, healthcare providers rely on outside consultants for facilitating alternative investment processes. Therefore, it is important that their consultants support the investment audit process, while the responsibility for the institution’s financial statement assertions remains with management.
- The new AICPA guidelines sparked controversy with the claim that, in certain circumstances, existence must be confirmed on a security-by-security basis. Many hedge fund managers are not willing to disclose this level of detail. In other circumstances, the AICPA declares that a security-by-security listing of fund holdings will not provide sufficient evidence to support the existence assertion. Auditors were confused about what information to request from fund managers, and what to do with information that was provided. This confusion raised concerns that auditors would have to disclaim opinions or issue qualified opinions with scope limitations. Qualified audit opinions can have dramatically negative consequences for healthcare providers, including; violations of debt covenants, debt rating agency downgrades and challenges for philanthropic fund raising efforts.
- Strong risk assessment and internal controls are essential elements of the investment process throughout the year. Effective documentation and communication of these processes helps demonstrate to auditors that the healthcare provider’s financial statements do not have a material misstatement risk attributable to alternative investments.

### ICPA Section 9332 Audit Guidelines

In the last half of 2006, audit firms struggled with new requirements under the AICPA’s Section 9332 regarding investments where a readily determinable fair value does not exist. A Practice Aid for Auditors describes these as “investments not listed on national exchanges or over-the-counter markets, or for which quoted market prices are not available from sources such as financial publications, the exchanges, or the National Association of Securities Dealers Automated Quotations System (NASDAQ). In addition to alternative investments (hedge funds, private equity and real asset partnerships), Section 9332 requirements apply to commingled funds investing in traditional asset classes.

The audit guidelines state that third party confirmations, either in aggregate or with security-by-security detail, do not alone constitute adequate audit evidence for determining fair market value. Unfortunately, the interpretation does not expand on what would suffice as adequate existence and valuation evidence.

Management is responsible for the accounting, financial reporting and control processes used to determine the fair value of investments. Auditors are responsible for understanding and testing these processes.

**Auditor Perspectives on Alternative Investment Risk** An auditor's job is to assess the material misstatement risk (MMR) of the investor's financial statements. Materiality is a matter of the auditor's independent professional judgment, and includes qualitative and quantitative considerations. The audit process focuses on the existence and valuation assertions made in preparing management's financial statements.

Alternative investment valuation risks are attributable to: the inability to challenge manager valuations; manager pressure to overstate values due to performance-based compensation; and poor transparency of underlying investments. These risks are mitigated by the due diligence process in selecting and monitoring investment managers. These processes are usually conducted by outside investment consultants on their client's behalf.

Auditors first determine whether alternative investments present a MMR of the investor's financial statements by assessing the:

- Allocation relative to the overall Balance Sheet;
- Complexity and liquidity of underlying assets;
- Internal valuation controls;
- Information available to support management's valuation process and key assumptions.

After assessing the MMR presented by allocations to alternative investments, the auditor designs audit procedures to test the existence and valuation evidence available for each fund. These procedures will consider the inherent investment risk and the healthcare system's investment control processes to test the existence and valuation assertions.

We recommend separating alternative investments by the risk of valuation misstatement. Lower risk investments, like commingled stock and bond funds, require less evidence to validate the healthcare system's financial statement assertions. Complex illiquid investments, like funds of private equity funds, have a higher MMR and require more evidence to validate investor financial statement assertions.

Commingled fund managers provide existence and valuation evidence with a security-by-security listing of holdings and a statement of the investor's fund ownership percentage. Addressing the staleness of audited fund financial statements is the biggest challenge for these lower risk investments. Bridging the gap between the fund managers' audited financials and the institutional investor's year-end valuations can be the most time consuming part of the audit. However, much of this work can be completed in advance by reconciling manager financial statements to reported values, comparing the audited net asset value (NAV) to unaudited NAV's, evaluating fund performance relative to benchmark returns and confirming cash flows into/from funds.

Expediting the validation process for stock and bond commingled funds can go a long way in mitigating the overall MMR of the healthcare system's financial statements. This lets the auditor focus on higher risk (i.e., complex or illiquid) investments.

### Management Responsibility

The investor institution's management has responsibility for the valuation of alternative investments reported in audited financial statements. While management may look to the investment consultant and fund managers for valuation policies and assumptions, management must have effective processes to assess and independently challenge those valuations.

Taking *responsibility* includes demonstrating an understanding of the role for alternative investments in the portfolio strategy, the nature of underlying investments, and key valuation methods and assumptions. Investment consultants can support this responsibility with investment policy statements, manager selection due diligence reports, reviews of audited fund manager financial statements and summaries of fund manager valuation policies (including holdings and assumptions). Investment Committee discussion documents also provide evidence of investment process responsibility.

*Effective processes* for supporting fair value estimates demonstrate that management understands the nature and performance of underlying investments in alternative funds. Auditors can evaluate these processes by reviewing fund

manager statements and the consultant's performance analysis reports. The consultant's manager evaluation reports provide helpful summaries of preselection and ongoing due diligence efforts. Significant changes in fund strategies and valuation policies will usually be highlighted in the consultant's ongoing manager performance reviews.

Healthcare management can help the auditor's efforts by providing a general investment portfolio strategy review at the beginning of the audit process. The review can begin with a brief description of the Investment Committee's decision process used in setting asset allocation policies and selecting fund managers. The review will also highlight the funds where "readily determinable values do not exist", and provide an opportunity to describe the nature, liquidity and complexity of each investment. This discussion will aid the auditor's MMR assessment, and save time during the on-site portion of the audit.

Investment due diligence controls are difficult to link to an institution's financial statement valuation assertion, and do not replace internal financial reporting controls. However, this background information does demonstrate a strong process for supporting fair value estimates. Details on specific manager valuation policies will focus the auditor's attention to the specific evidence needed to test the most pertinent valuations. The institution's management does not need to recalculate estimated fair values unless they become aware of incorrect methodologies and assumptions.

### **Auditor Responsibility**

The auditor begins by understanding the investor institution's process for developing its fair value estimates and the controls that have been established to maintain confidence in those estimates. Next, the auditor identifies and assesses risks associated with financial statement assertions to determine any MMR. These include:

- Significant allocations to alternative funds;
- Transparency of underlying investments;
- Portion of the portfolio that is marketable;
- Diversification or concentration risk;
- Illiquidity – redemption risks and lock-up periods;
- Ownership structure (LLC, LP, etc.); and,
- Staleness of fund audited financial statements.

Finally, the auditor designs procedures to validate existence and valuation assertions to reduce the MMR to acceptable levels. The quality and quantity of evidence required varies according to the nature, complexity, transparency, volatility and illiquidity of each alternative investment fund. The investor institution sends information requests to each alternative fund manager based on the quantity and quality of information required by the auditor. The evidence is often sent from the manager directly to the auditor to expedite the review process.

The auditor's evaluation usually begins with funds that have the highest asset allocation and moves to smaller allocations until the portion of the portfolio that does not have readily determinable values drops below the materiality threshold. Valuations are rolled forward from the fund's year-end to the investor institution's year-end, with an assessment of the funds' valuation policies, audit opinions and basis of accounting.

For most healthcare institutions, traditional asset class commingled funds make up the largest allocations to investments that do not have readily determinable fair values. For commingled funds, auditors usually begin with the most recent audited financial statements, a security-by-security list of holdings and the fund manager's statement of the investor's percent interest in the fund. The time gap between the fund audit date and the investor's year end is bridged by validating cash flows into and from the fund, and the fund's performance. Managers' stated performance is corroborated with benchmark performance.

As the auditor's focus shifts to more complex and illiquid alternative investments, there will be some funds where sufficient existence and valuation evidence is not attainable. However, in most cases, these will not break the materiality barrier when the overall due diligence, monitoring and control processes are well documented.

### Conclusion

Responding to the new AICPA guidelines will become easier as confusion subsides over what evidence should be gathered, and what auditors should do with that evidence to validate financial statement assertions. In some cases, healthcare management has mistakenly been led to believe that they are on their own in supporting the audit process. Unfortunately, the guidelines do not clarify how the healthcare provider's outside investment consultant can assist in articulating the role for alternative investments and documenting the due diligence and control processes.

Important lessons have been learned with healthcare providers' first pass through the new audit guidelines. Processes that are not documented cannot be audited, so improved documentation and data collection will expedite subsequent investment portfolio audits.

Much of the support evidence can be gathered in advance of the audit process. Healthcare management should ask fund managers for underlying investment details as close as possible to the institution's balance sheet date. For each alternative fund, ask how the investment consultant gets comfortable with valuations, including; risk assessment, site visits, benchmark and peer performance comparisons, review of valuation policies, "key manager" provisions, and monitoring changes in the fund manager people, processes and strategies.

In general, policies and processes have always been in place for well-designed alternative investment programs. The new AICPA audit guidelines provide an opportunity to document and communicate these due diligence processes to outside auditors.

Please contact me for a due diligence checklist, or other ideas that may help prepare your audit team's review of investments that do not have readily determinable valuations.

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