Hammond Associates
Recommended Procedures for
Audits on Alternative Investments

HammondAssociates
INSTITUTIONAL FUND CONSULTANTS, INC.

Recommended Client Procedures for Audits on Alternative Investments

Hammond Associates
December 2006

TABLE OF CONTENTS

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December 2006

A. Overview and Purpose

On July 18th of 2006, the American Institute of Certified Public Accountants (AICPA) issued a Practice Aid (officially titled, "The Alternative Investments-Audit Considerations, a Practice Aid for Auditors," see **Section III** of this report). The current AICPA Practice Aid (it has not been updated since originally issued) states that investors of alternative investments are responsible for the valuation of their alternative investments. This responsibility necessitates that they have a sufficient understanding of the following;

- the nature of the underlying investments,
- the portfolio strategy of the alternative investment, and
- the valuation process used by the alternative investment manager.

The investor should establish internal controls that include initial and ongoing due diligence, in their valuation process and follow the process to be reasonably assured that the existence and value of their assets is in accordance with their stated accounting policies.

Our experience since July 2006 has shown that while the interpretation of the standards is auditor-specific, generally auditors are evaluating an investor's due diligence process and system of internal controls with an eye toward thoroughness and consistency. The better the client understands the manager/general partner and the better the quality of controls, the better the client will be able to understand valuations and the less chance of a material misstatement of their financials.

To assist our clients with this process, we have prepared this report titled, "**Recommended Procedures for Audits on Alternative Investments.**" This report may evolve over time as best practices tend to do. It includes a list of documents and procedures designed to assist our clients in their audits on alternative investments, along with Hammond Associate's internal due diligence process for alternative investments. We recommend that Hammond Associates' consultant review this document with every client annually, before the fiscal year-end.

In ***Part B***, we list **Key Documents** for our clients to review and maintain on alternative investment managers. (We focus primarily on private equity and hedge funds, but commingled funds and private real estate are also considered). Included are initial fund documents, such as the private placement memorandum and subscription agreements, as well as ongoing communications: annual and quarterly reports, audited financial statements, and letters from managers.

In ***Part C,*** we provide **Recommended Procedures** to assist clients in preparing for their annual audits involving alternative investments. For example, to keep up-to-date on their alternative investments, we recommend that clients participate in their alternative investment managers' webcasts and conference calls. This includes the ability to question management, if desired. Doing on-site visits to alternative investment managers, attending their annual meetings, or having managers attend a client's Committee meeting, when feasible, are also recommended.

In ***Part D***, we note the considerations involved for investments in "fund-of-fund" and commingled managers.

In ***Part E***, we provide **Hammond Associates' Due Diligence Process**. This is divided into initial due diligence (before we recommend an alternative investment manager) and ongoing due diligence. Our due diligence processes follow the outline of the standards suggested in the AICPA's Practice Aid. The AICPA Practice Aid, as it currently reads, states that the clients themselves must follow procedures to value their alternative investments and cannot delegate this responsibility to an outside party (see page 4 of the AICPA Practice Aid).

We follow what we believe to be a thorough due diligence process for any alternative investment manager we recommend. It is beyond the scope of our team to audit our recommended managers, so in part we rely on accounting professionals performing their duties reliably, thoroughly and with integrity.

B. Key Documents

Basically, clients should review and save all documents and correspondence with alternative investment managers. They may want to consider establishing a formal procedure for collecting these key documents, such as a document log.

Clients should read and have the following alternative manager documents and committee notes/minutes accessible:

a) Name and contact information of Alternative Managers
b) Offering Memorandum / Private Placement Memorandum (PPM) **with special attention paid to the valuation process outlined in the document**
c) Updated PPMs (if applicable)
d) Copy of the Executed Subscription Agreement
e) Annual Audited Financial Statements
f) ADVs (if applicable - applies primarily to hedge funds))
g) Copies of alternative manager's due diligence questionnaire (if available)

h) Unaudited quarterly financial reports/statements/NAVs, quarterly shareholder letters
i) Initial alternative investment manager (partnership / manager / fund) evaluation prepared by Hammond Associates
j) Quarterly Investment Review prepared by Hammond Associates that discusses alternative manager(s) and the reasoning for the specific allocation to alternatives and how it fits in the overall portfolio
k) Documentation of other communications from Hammond Associates that are part of the due diligence process
l) Alternative manager's initial presentation/marketing book (flip book)
m) Documentation of reference checks on the alternatives managers
n) Capital account statements (should include capital calls and distribution information for private equity, and the corresponding wire authorizations)
o) Documentation and notes on meetings and correspondence with alternative managers, and attendance at the alternative managers' annual conferences
p) Committee meeting minutes outlining internal discussions on alternative investments

C. Recommended Procedures

We recommend that our clients review and follow the examples of due diligence, ongoing, monitoring, and financial reporting controls outlined in the AICPA Practice Aid (see pages 20-22 of the Practice Aid in **Section III**). Our recommended procedures, outlined below, closely follow many of the examples in the Practice Aid, and are designed to aid the client in gaining a better understanding of the valuation of their alternative investments, as well as to assist them in their audit;

Initial Due Diligence Procedures

1. Maintain the aforementioned documents in a readily accessible place with a document log.

2. Review each document before subscribing; consider having legal counsel review the initial documents.

3. When possible, check references with peers participating in the alternative investment and/or with committee members who may have experience with alternative investments on other boards or personally.

4. Document in the Investment Committee meeting minutes when the alternative investments are discussed and how the specific allocations fit in the portfolio.

5. Join in alternative investment manager's web casts if available, make an on-site visit to the alternative managers' offices, attend the alternative managers' annual conferences, suggest a teleconference between the Committee and the manager, or arrange a face-to-face meeting with the manager.

6. When reviewing the alternative manager's financial statements, note, investigate, and document significant issues such as changes in the auditor or in valuation procedures.

7. Compare Hammond Associates' performance calculations to the alternative investment manager's statement and to prior statements for reasonableness.

8. Contact the auditors prior to the client's fiscal-year-end to ask about the documents and other materials needed for the alternative investment audit, to prepare the audit-requested letters (see pages 17-18 of the AICPA Practice Aid for sample confirmation letters, **Section III**), and to draft requests to the alternative investment managers.

9. Maintain a private equity spreadsheet. Many private equity managers are on a calendar year-end reporting cycle, while schools typically have a June 30th fiscal year-end. Thus, auditors must reconcile 12/31/XX private equity statements to the client's June 30th investment statement. One way for the client to better understand the June 30th alternative investment valuations, to ensure that the most accurate financial reports are issued, and to assist the auditors in this reconciliation process, is to maintain a private equity spreadsheet. (For a sample, see **Section II** of this report**)**.

D. Fund-of-Fund and Commingled Managers

Fund-of Funds: Due to the time involved in compiling the underlying managers' financial statements, the statements on fund of funds ("FoF") tend to be available later than those of direct hedge funds and private equity managers.

Commingled Funds: Commingled funds typically are comprised of marketable securities. Commingled managers can provide existence and valuation evidence with a security-by-security listing of holdings and a statement of the investor's fund ownership percentage. Valuations are rolled forward from the fund's year-end to the investing institution's year-end, with an assessment of the fund's valuation procedures, audit opinions, and accounting policies.

E. Hammond Associates' Due Diligence Process

The steps below describe Hammond Associates initial and ongoing due diligence processes. Not all of the processes listed below apply to every sub-class of alternative investments or to all investments under consideration. In some instances we indicate if the process pertains to only one sub-class, such as private equity.

Initial review

Note: During the initial review process, investments may be declined at any point.

1. Review of documents
    a. Private Placement Memorandum and other offering materials.
    b. Presentation materials (marketing material and/or flip book).
    c. Recent annual audited financial statements (when available - first time funds will not have audited financial statements).

   d. Copy of the alternative manager's due diligence questionnaire (if available).
   e. Quarterly financial reports / statements / NAVs.
   f. *(For hedge funds)* 13F filings if available and manager disclosures.

2. Initial Manager meeting
   a. Typically meet with the partners / portfolio managers.
   b. Overview of firm strategy, people, structure, outlook for future funds, etc.

3. Screen for portfolio fit (look at current client portfolio to see if this particular strategy is needed).

4. In depth review includes the following:
   a. Quantitative and qualitative assessment of team, strategy, track record, and terms.
   b. *(For hedge funds)* Initial quantitative analysis (performance and risk statistics).
   c. Reference checks with internal network, other investors, former employees, portfolio company management teams, educational credentials, etc. as needed.
   d. Reference checks provided by manager (may include current and former clients).
   e. Reference checks with service providers (e.g. auditor, legal counsel, administrator, etc.).

5. On site interview/review/visit
   a. (*For private equity*) Follow Hammond Associates "*Limited Partnership On Site Review Guide*" (guide includes thorough analysis of partners, investment strategy including deals and target markets, valuations, sourcing, decision making process, exit strategies, legal issues, fees, calculation of returns, etc.).
   b. *(For hedge funds)* Operational review. Review of trades, controls, security valuation processes, etc.
   c. *(For hedge funds) A*ssess pricing policy following Hammond Associates' ***"Hedge Fund Manager Pricing Due Diligence"*** (see **Section IV** of this report). This is accomplished through communications with the manager and auditor, and reviewing audited material. The process for valuation is often detailed in the offering materials.
   d. Meet pertinent personnel.
   e. Review outstanding issues from research.

6. Prepare the Manager, Partnership, or Fund Evaluation

7. Review and approval by Hammond Associates Internal Investment Committee

<u>Ongoing Due Diligence and Monitoring</u>

1. Performance Monitoring
   a. Track all client investment cash flows for reporting
   b. *(For private equity)* Monthly calculate and review private equity internal rate of returns (IRR), cumulative returns on

investment (ROI), and other statistics. (*For hedge funds)* Compare reported performance to audited data. Monthly/quarterly, review managers' sector exposure reports. Analyze reported returns relative to expectations, peers, and exposures in light of market events.

c. *(For private equity)* Review internal reports, "reporting by exception" process highlights outliers for special review.

2. Internal Reports
   a. Review all clients' monthly performance summaries.
   b. Note and investigate any performance drivers such as significant changes in flows, returns, or valuations.
3. Meetings with Managers
   a. Have ongoing dialogues with managers, on-site, in our offices, via phone, and/or email (a contact log is maintained).
   b. When possible, attend annual meetings; listen to quarterly / annual conferences, calls, web casts, etc.
   c. Review updated manager documents.
4. Indirect Contact
   a. Constantly utilize internal reference network.
   b. *(For hedge funds)* Review regulatory filing reviews (e.g., 13F / Form ADV if available).
   c. Review annual audits.
5. Review of Quarterly and Annual Reports
   a. *(For private equity)* Read Shareholder/Manager letters, review portfolios for signs of progress or trouble.
   b. *(For hedge funds)* Review manager exposure reports for appropriateness and reasonableness of returns.
6. Advise clients on post-closing actionable events relating to the alternative investments.
7. Advise clients on any material changes in manager documents and other important events (e.g. structural changes).

-END-

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Section I
Private Equity Spreadsheet

The spreadsheet should begin with the initial commitment and show subsequent capital calls and distributions. Some private equity managers break out the fees and interest and the client can also track them in the spreadsheet.

When the quarterly valuation for an investment is received, the client should enter it into the corresponding capital account balance column for that particular quarter-ending month (in bold). The other monthly capital account balances (non-quarter-ending months) are simply running totals. The capital account balances for non-quarter ending months are calculations based on the previous month's ending capital account balance, plus the current month's capital calls, less the current month's distributions.

Table 1: Sample Private Equity Spreadsheet

General Partner:	**Sample Priv Equity GP #1**		
Fund name:	**GP #1's Priv Equity Fund #7**		
Commitment:	$ 3,000,000		
Inception:	08/31/05		
Date	**"C" Capital Account Balance**	**"A" Capital Calls**	**"B" Distributions**
31-Aug-05	90,000	(90,000)	
30-Sep-05	**74,092**		
31-Oct-05	104,092	(30,000)	
30-Nov-05	104,092		
31-Dec-05	**299,325**	(180,000)	12,343
31-Jan-06	539,325	(240,000)	
28-Feb-06	497,889		41,436
31-Mar-06	**599,506**		
30-Apr-06	839,506	(240,000)	
31-May-06	781,433		58,073
30-Jun-06	**724,164**		62,074
31-Jul-06	699,504		24,660
31-Aug-06	699,504		
30-Sep-06	**699,504**		
31-Oct-06	699,504		
31-Oct-06	*699,504*	*(780,000)*	*198,586*

Bolded = capital balance is from a quarterly statement

non-Bolded = previous month's capital balance, plus capital calls (A) less distributions (B)

ALTERNATIVE INVESTMENTS – AUDIT CONSIDERATIONS

A PRACTICE AID FOR AUDITORS

AICPA

Notice to Readers

This document is intended to provide auditors with information that may help them improve the effectiveness and efficiency of their audits and practices, and is based on existing professional literature, the experience of members of the AICPA's Alternative Investments Task Force, and information provided by certain AICPA member firms to their own professional staff. This information represents the views of AICPA staff based on the input of the members of the Alternative Investments Task Force and has not been approved by any senior technical committee of the AICPA. The auditing portion of this publication is an *Other Auditing Publication* as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1), and is intended to provide guidance to auditors of nonissuers.[1] *Other Auditing Publications* have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards. If an auditor applies the auditing guidance included in an *Other Auditing Publication*, the auditor should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the subject audit, and appropriate. This publication was reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA, and is presumed to be appropriate.

[1] The term *issuer* is defined in Section 2 of the Sarbanes-Oxley Act as an issuer (as defined in Section 3 of the Securities Exchange Act of 1934), the securities of which are registered under Section 12 of that Act, or that is required to file reports under Section 15(d), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933, and that it has not withdrawn.

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TABLE OF CONTENTS

Foreword

This Practice Aid addresses challenges associated with auditing investments for which a readily determinable fair value does not exist (that is, 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)). These investments include private investment funds meeting the definition of an *investment company* under the provisions of the AICPA Audit and Accounting Guide *Investment Companies*, such as hedge funds, private equity funds, real estate funds, venture capital funds, commodity funds, offshore fund vehicles, and funds of funds, as well as bank common/collective trust funds. Collectively, these types of investment funds are referred to herein as “alternative investments.” Alternative investments may be structured as limited partnerships, limited liability corporations, trusts, or corporations.

Investors in alternative investments include, but are not limited to, colleges and universities, hospitals, pension plans, and investment companies – including funds of funds. Some of these entities invest a small percentage of their investment portfolios, while others invest a substantial percentage of their total investments in these vehicles. Some of these investors invest in a single alternative investment, while other investors have portfolios of hundreds of alternative investments. In addition, the underlying investments of the alternative investments can range from marketable securities to complex and/or illiquid investments. Alternative investments can present challenges with respect to obtaining sufficient appropriate audit evidence in support of the existence and valuation assertions, because of the lack of a readily determinable fair value for these investments and the limited investment information generally provided by fund managers.

General Considerations Pertaining to Auditing Alternative Investments

The principal auditing standard for investments is AU section 332, *Auditing Derivative Investments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards,* vol. 1). AU section 332.21 describes procedures for obtaining audit evidence relating to the existence assertion. AU section 332, paragraphs .28 through .34, describes auditing procedures relating to the valuation assertion where valuation of the investments is based on the investee’s financial results, and AU section 332, paragraphs .35 through .46, describes procedures relating to the valuation assertion where valuation of the investments is based on estimated fair value. AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1), also addresses auditing issues relevant to investments.

Although the guidance in AU section 332 and AU section 328 pertains to alternative investments, such guidance was not intended to be specific to alternative investments.

Interpretation No. 1, "Auditing Investments in Securities Where a Readily Determinable Fair Value Does Not Exist," of AU section 332 (the Interpretation) was issued to assist auditors in applying the provisions of AU section 332 to alternative investments. The Interpretation provides auditing guidance related to the existence and valuation assertions for investments in securities where readily determinable fair values do not exist.

This Practice Aid focuses on the existence and valuation assertions associated with alternative investments. The auditor's approach is based on an assessment of the risk of material misstatement of the financial statements. As stated in AU section 312.11, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1), the auditor's consideration of materiality is a matter of professional judgment, and materiality judgments involve both quantitative and qualitative considerations. The risk of material misstatement includes inherent risk and control risk.

The auditor's risk assessment depends on the particular facts and circumstances, including (1) the significance of alternative investments to the financial statements; (2) the nature, complexity, and liquidity of the underlying investments; (3) the nature and extent of management's process and related internal controls associated with valuation of alternative investments; and (4) the nature and extent of information available to management to support its valuation process and valuation conclusions. When an investor entity has a significant number of individual alternative investments, for the purpose of assessing risk, the auditor may need to group the alternative investments based on similar characteristics and/or processes.

The auditor often obtains sufficient appropriate audit evidence with respect to the existence and valuation assertions associated with alternative investments in the form of (1) observable market prices (for example, from recent sales or purchase transactions), (2) details of values in the underlying investments, or (3) audited financial statements of the alternative investment. 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.

Existence Assertion

The existence assertion addresses whether alternative investments exist at a given date, and whether recorded transactions have occurred during a given period.

The auditor obtains an understanding of internal control sufficient to plan the audit by performing procedures to understand the design of controls relevant to the audit and determine if they have been placed in operation. The discussion of internal control in this document is included in the section on the valuation assertion; however, certain of the controls in that section also are relevant to the existence assertion.

For investments in alternative investments, the auditor typically confirms with the fund manager the investor entity’s interest in the fund (for example, number of units held or percentage ownership, and value of the investor entity’s proportionate share of net assets/capital account balance) as of the balance sheet date. The Interpretation provides guidance on this confirmation process. The Interpretation states that, in circumstances in which the auditor determines that the nature and extent of audit procedures should include verifying the existence of alternative investments, simply confirming investments in the aggregate does not constitute adequate audit evidence with respect to the existence assertion. The Interpretation also states that, if the auditor concludes that the nature and extent of audit procedures should include confirming existence of the entity’s investments, confirmation of the holdings of the alternative investments on a security-by-security basis typically would constitute adequate audit evidence with respect to the existence assertion. Refer to Appendix 1 for an illustrative confirmation for use by practitioners.

The auditor’s uncertainty as to whether the fund manager will provide the requested information does not obviate the auditor’s requirement to obtain sufficient appropriate audit evidence – either through confirmation or otherwise. If the confirmation request is not returned to the auditor or the details of the underlying investments are not otherwise provided by the fund manager, the auditor performs alternative procedures directed toward assessing existence of the alternative investments. In addition, depending upon the significance of the alternative investments to the investor entity’s financial statements taken as a whole, even if the fund manager confirms all requested information, it may be necessary for the auditor to perform additional audit procedures. Such alternative or additional procedures may include:

- Observing management site visits or telephone calls to investee funds (or reviewing documentation of such calls or visits)
- Reviewing executed partnership, trust, limited liability corporation, or similar agreements
- Inspecting other documentation supporting the investor’s interest in the fund (for example, correspondence from the fund or trustee acknowledging transactions with the fund)
- Reviewing periodic statements from the fund or trustee reflecting investment activity and comparing activity with amounts recorded by the investor
- Vouching relevant cash receipts and disbursements

Determining whether one or more of these alternative or additional audit procedures provides the auditor with sufficient appropriate audit evidence with respect to the existence assertion requires considerable auditor judgment.

Valuation Assertion

The valuation assertion addresses whether alternative investments are reflected in the investor entity's financial statements at appropriate amounts.

Alternative investments may be accounted for under three basic accounting methods: cost, equity (valuations based on an investee's financial results), or fair value. The determination of the appropriate accounting method is dependent on various factors, including the type of investor entity (for example, not-for profit, health care, investment company, or employee benefit plan), structure of investment entity (for example, partnership vs. corporation), and the percentage ownership. Auditing management's valuation assertion includes considering the appropriateness of the accounting method used for measurement and disclosure. Even in situations where the cost or equity method are required to be used as the carrying amounts for alternative investments, consideration must be given to fair value disclosures required by generally accepted accounting principles (GAAP).

Investor Management's Responsibility for the Valuation Process and Related Internal Control

The auditor's consideration of the valuation assertion typically begins with understanding the process used by the investor entity's management in developing its fair value estimates and the controls that have been established relative to those estimates.

Management of the investor entity is responsible for the valuation of alternative investment amounts as presented in the investor entity's financial statements. With respect to valuations based on fair value, AU section 328.04 states:

> *Management* is responsible for making the fair value measurements and disclosures included in the financial statements. As part of fulfilling its responsibility, *management* needs to establish an accounting and financial reporting process for determining the fair value measurements and disclosures, select appropriate valuation methods, identify and adequately support any significant assumptions used, prepare the valuation, and ensure that the presentation and disclosure of the fair value measurements are in accordance with GAAP. [Emphasis added]

This responsibility cannot, under any circumstances, be outsourced or assigned to a party outside of the investor entity's management. Although the investor entity's management may look to the fund manager for the mechanics of the valuation, management must have sufficient information to evaluate and independently challenge the fund's valuation. The underlying investments generally are measured at estimated fair value by the fund manager in accordance with its stated valuation policies for determining net asset value.

Taking responsibility for the valuation of the alternative investments will necessitate that the management of the investor entity has a sufficient understanding of the nature of the underlying investments, the portfolio strategy of the alternative investments, and the method and significant assumptions used by the fund manager to value the underlying investments. The nature and extent of management's process for valuing investments, and the related internal controls, are particularly important when the investor entity invests in securities for which readily determinable fair market values do not exist. In these instances, 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.

An effective process for supporting fair value estimates of alternative investments includes the investor entity's management having an understanding of the underlying investments. The timing and extent of the understanding is based upon management's assessment of the risk of material misstatement of the financial statements. In higher risk situations, an effective valuation process may include periodic access to a detailed listing of the underlying investments along with their estimated fair values and, if relevant, the related debt or other obligations of the alternative investment.

In the absence of availability of a detailed listing of the underlying investments as of the investor entity's year end, the investor entity's management may gain sufficient understanding of the fund through other activities. These activities could include, but not be limited to, periodic interviews with fund management to understand the fund's strategy, positions, and valuation methodologies sufficient to provide the investor entity's management with the ability to compare the data obtained from the fund manager with other available information, such as sector data, indexes, and cash distributions. Such data could be further corroborated with information regarding the underlying investments obtained through the annual audited financial statements of the alternative investment.

The extent of the process utilized by the investor entity's management and the related controls should reflect the significance of the alternative investments to the investor entity's financial statements, the nature of the underlying investments, and management's risk assessment. A smaller portfolio of alternative investments that are themselves invested in readily marketable securities ordinarily requires a less sophisticated process and related controls than a large portfolio of alternative investments with underlying investments that are more complex and difficult to value. Management's process may include a variety of approaches due to the different types of alternative investments within its portfolio.

Management's valuation process need not include recalculation of estimated fair values for alternative investments, but it should ensure that the investor entity's management has a sufficient understanding of the characteristics of the underlying investments and the alternative investment's valuation process for investments held as of the investor entity's balance sheet date. As such, the investor entity need not prepare a separate valuation of the underlying investments unless it becomes aware that valuation methodology or assumptions used by the fund manager are incorrect, incomplete, or otherwise unsatisfactory. Although obtaining the detail of the underlying investments may indicate a strong process, simply obtaining the detail is not sufficient by itself for management to support its assertion regarding the valuation of the alternative investments.

Refer to Appendix 2 for illustrative examples of due diligence (that is, those procedures performed before the initial investment), ongoing monitoring (that is, those procedures performed post-investment), and financial reporting controls. These examples are intended to assist auditors in evaluating management's process. However, the examples are not intended to be all-inclusive or to be used as a checklist. Due diligence controls are key elements of an investor entity's risk management. However, due diligence controls are by their nature difficult to link to the financial statement valuation assertion and do not replace controls over monitoring and financial reporting in support of the valuation process.

Auditor's Approach

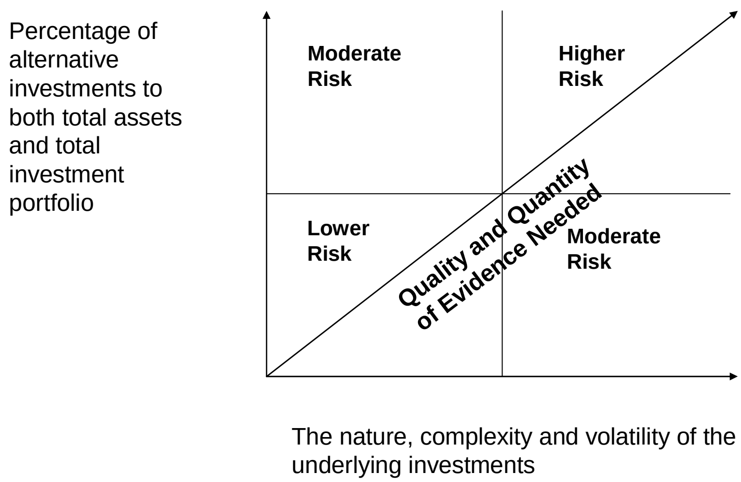
The auditor's approach is based on an assessment of the risk of material misstatement of the financial statements. This approach includes (1) an identification of the risks associated with relevant financial statement assertions, (2) an assessment of those risks, (3) a determination of the significant risk of material misstatement, and (4) the design of procedures responsive to those significant risks so as to reduce such risks to the acceptable level to enable the auditor to express an opinion on the financial statements taken as a whole.

The auditor should consider the sufficiency and appropriateness of audit evidence to be obtained when assessing risks and designing further audit procedures. Sufficiency is the measure of quantity of audit evidence. Appropriateness is the measure of the quality of audit evidence, that is, its relevance and reliability in providing support for, or detecting misstatements in, the classes of transactions, account balances, and disclosures and related assertions. The quantity of audit evidence needed is affected by the risk of misstatement (the greater the risk, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality of audit evidence, the less the audit evidence that may be required). Accordingly, the sufficiency and appropriateness of audit evidence are interrelated. However, merely obtaining more audit evidence may not compensate if it is of lower quality. As illustrated in Exhibit 1, "Risk Assessment," the extent of the audit evidence necessary for the auditor to conclude on the sufficiency and the appropriateness of audit evidence increases as:

1. The percentage of alternative investments to both total assets as well as the total investment portfolio increases.
2. The nature, complexity, and volatility of the underlying investments increases.

Exhibit 1

Risk Assessment



As the risk moves into the upper right quadrant of the graphic, the need for higher quality and a greater quantity of audit evidence increases. Audited financial statements of the alternative investment as of the investor entity’s balance sheet date are among the highest quality audit evidence. Limited visibility into the underlying investments detracts from the quality of the audit evidence, while a detailed listing of the underlying investments as of the date of the investor entity’s year end enhances the quality of audit evidence. A fund’s condensed schedule of investments or a detailed listing of the underlying investments as of a date other than the investor entity’s year end may provide some audit evidence that falls between these two extremes. The evaluation of the quality of such evidence is subject to the auditor’s professional judgment.

To illustrate, consider the following four examples. The examples are for illustrative purposes only and are not intended to create specific parameters.

Example 1. If 5 percent of the investor entity’s net assets are in alternative investments, and the underlying investments have readily determinable market values, the risk of material misstatement may be assessed as lower. Therefore, the quality and quantity of audit evidence that the auditor would need to obtain in order to conclude that the financial statements are not materially misstated may be lower.

Example 2. If 5 percent of the investor entity’s net assets are in alternative investments, and the underlying investments are complex and/or illiquid (such as investments in natural resources or start-up entities), the risk of material misstatement may be assessed as moderate. The auditor might conclude that the quality and quantity of audit evidence necessary to conclude that the financial statements are not materially misstated would be moderate.

Example 3. If 35 percent of the investor entity's net assets are in alternative investments, and the underlying investments are in vehicles with a readily determinable market value, the risk of material misstatement may be assessed as moderate, as the lower inherent risk associated with these types of underlying investments mitigates the risk associated with the significance of the investments to the financial statements taken as a whole. The auditor exercises professional judgment in determining the sufficiency and appropriateness of audit evidence to conclude that the financial statements are not materially misstated.

Example 4. If 35 percent of the investor entity's net assets are in alternative investments, and the underlying investments are complex, volatile or illiquid (such as investments in natural resources or start-up entities), the risk of material misstatement may be assessed as higher, as the increased inherent risk associated with the more esoteric investments is compounded by the significant impact a misstatement would have on the financial statements taken as a whole. Therefore, the quality and quantity of audit evidence that the auditor would need to obtain would be higher.

Obtaining an Understanding of Internal Control

In accordance with AU section 319, *The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), the auditor obtains an understanding of internal control sufficient to plan the audit by performing procedures to understand the design of controls over financial reporting and determine if they have been placed in operation. With respect to valuations based on estimated fair values, when obtaining an understanding of internal control related to valuation, the auditor might consider the following:

- Management's process used to determine the estimated fair value of the investments, including the selection and consistent application of the relevant accounting principles and valuation methods
- The availability of information used in determining estimated fair value, including any details of the underlying investments of a hedge fund or investment partnership that may be available to investor entities
- The nature of the underlying investments, including the complexity of the investment strategies, the liquidity of the principal trading markets, and the frequency of trading activity (that is, frequently moving in and out of various trading positions or hedging strategies)
- How often management interacts with the fund manager and the nature of such interactions, including the extent to which they enable management to estimate fair value as of the balance sheet date
- The competence and experience of the investor entity's personnel assigned to monitor and estimate the fair value of the investor entity's investments, particularly investments in hedge funds or similar vehicles using complex investing strategies

- The availability of SAS 70 reports surrounding the controls and procedures in place at a service provider, in the determination of unit values and shareholder transactions such as for common/collective trust funds
- Use of an investment adviser to monitor the alternative investments, including the underlying investments, and/or to monitor markets or market indicators and their effect on the estimated fair values of the entity's investment
- The availability of audited financial statements for the alternative investments and whether such statements are as of the same date as the client's financial statements, the timing of when such audited financial statements become available, and whether the audits are conducted by qualified and reputable independent audit firms

The illustrative controls outlined in Appendix 2 may assist auditors in identifying relevant controls. While due diligence controls (that is, those procedures performed before the initial investment) are a key element of an investor entity's risk management, extensive due diligence does not replace controls over monitoring (that is, those procedures performed post investment) and financial reporting.

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.

The auditor considers the results of the internal control testing and determines whether significant deficiencies or material weaknesses in the design or operation of internal control with respect to management's process for valuing alternative investments exist. These matters may include:

- 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 information, including visibility into the underlying investments, to support the financial statement assertions relative to the estimate of fair value of assets of significant alternative investments
- Instances in which the alternative investment's risk profile does not appear to be consistent with the entity's investment policy

Based on the auditor's understanding of the process and of the results of tests of related controls, if any, the auditor assesses the risk of material misstatement. Based on that risk assessment, the auditor determines the nature, timing, and extent of the substantive audit procedures.

Fair Value Method of Accounting

In determining the nature, timing, and extent of auditing procedures to be applied to a specific account balance or class of transactions, the auditor designs procedures to obtain reasonable assurance of detecting misstatements that he or she believes, based upon the preliminary judgment of materiality, could be material, when aggregated with misstatements in other balances or classes, to the financial statements taken as a whole, (AU section 312.25). Whether one or a combination of substantive procedures is used to address a particular assertion-level risk depends on the auditor's assessment of the inherent and control risk, as well as the auditor's judgment about a procedure's effectiveness (AU section 332.19).

When alternative investments are accounted for at fair value, the valuation assertion may involve significant judgment by management in the assessment of the estimate of fair value of the investment. The more complex or illiquid the investment and/or the lack of sufficient management processes and records over valuation, the greater the risk of misstatement, and the more persuasive audit evidence that needs to be obtained by the auditor.

The auditor's understanding of the reliability of the process used by the investor entity's management to determine estimated fair value is an important element in support of the resulting amounts and therefore affects the nature, timing, and extent of audit procedures. The auditor may test management's fair value estimate as of the balance sheet date by using one or more of the following approaches. The approach(es) taken may not be the same for all alternative investments in an investor entity's portfolio because the nature of the underlying investments and associated risk, as well as the information available to management and the auditor, likely will be different for each alternative investment. The higher the assessed risk of material misstatement, the greater the need for the auditor to utilize a combination of the following approaches. For additional guidance, auditors refer to AU section 328, paragraphs .26 through .39.

- *Confirm the alternative investment.* The Interpretation states that if the auditor determines that the nature and extent of auditing procedures should include testing the measurement of the investor entity's investment, simply receiving a confirmation from the alternative investment of its investments in securities, either in aggregate or on a security-by-security basis, does not, in and of itself, constitute adequate audit evidence with respect to the valuation assertion. The extent of the additional audit procedures is directly related to the assessed risk of material misstatement of the financial statements.
- *Review and test the investor entity's significant assumptions and the underlying data in its valuation or its analysis of the assumptions and data obtained from the fund manager.* A confirmation on a security-by-security basis may provide support of the data used by investor's management in its valuation process. In

drafting a confirmation, the auditor considers requesting a description of each investment, ownership percentage, or shares owned and estimated fair value. If detailed information is not available, the auditor looks to the other data that management used in its valuation and performs tests on such data. The nature of the tests depends on the types of data used by management and the auditor's assessment of the risk of material misstatement of the financial statements.

- *Reconcile to audited financial statements as of the same date*. If audited financial statements of the alternative investment are available as of the date of the investor entity's year end and the alternative investment follows fair value accounting, the audited financial statements and an accompanying auditors' report may provide significant audit evidence regarding the valuation of the investment. However, the investor entity and the fund often have different fiscal year ends. In lower or moderate risk situations, the auditor might be able to perform additional procedures, such as obtaining interim financial information and testing management's tracking analysis.
- *Review transactions at or near the balance sheet date.* Evidence of an actual transaction, such as an investment in or liquidation of a portion of its alternative investment as of a date close to the investor entity's fiscal year end, may provide information for management to support the valuation of the alternative investment. The auditor may consider how often settlements occur and the terms used to determine the value of the settlement. Issues to consider include whether the process used for the settlement is the same process used for financial reporting; whether there are holdbacks or potential true-ups subsequent to the balance sheet date, and the possibility that the parties to the transactions were not both willing buyers and sellers, such as in a distress sale.

If management estimates the fair value of a significant portion of its alternative investments as of an interim date, management will need a robust process and strong internal control over the roll-forward period to the balance sheet date. Because the valuation assertion embedded in the financial statements is as of the balance sheet date, management needs to have the ability to obtain sufficient information to record the investments at estimated fair value as of the balance sheet date, including changes in the estimated fair value during the roll forward period. In this situation, the auditor tests both the estimation process as of the interim date and the roll-forward process.

Cost Method of Accounting

Pursuant to the guidance provided in AU section 332.28, when auditing the valuation assertion of alternative investments that are accounted for using the cost method, the auditor may consider substantive procedures such as:

- Confirming with the issuer or holder
- Inspecting documentation that indicates the purchase price of the investment
- Evaluating management's conclusion about the need to recognize an impairment loss for a decline in the investment's estimated fair value below its cost that is other than temporary

The auditor also audits the investor entity's estimated fair value disclosures, taking into account the considerations discussed in the previous section.

Equity Method of Accounting

AU section 332, paragraphs .28 through .30, provides guidance when auditing the valuation assertion of investments that are accounted for using the equity method:

> For valuations based on an investee's financial results, including but not limited to the equity method of accounting, the auditor should obtain sufficient evidence in support of the investee's financial results. The auditor should read available financial statements of the investee and the accompanying audit report, if any. Financial statements of the investee that have been audited by an auditor whose report is satisfactory, for this purpose,[1] to the investor's auditor may constitute sufficient evidential matter.
>
> If in the auditor's judgment additional evidential matter is needed, the auditor should perform procedures to gather such evidence. For example, the auditor may conclude that additional evidential matter is needed because of significant differences in fiscal-year ends, significant differences in accounting principles, changes in ownership, changes in conditions affecting the use of the equity method, or the materiality of the investment to the investor's financial position or results of operations. Examples of procedures the auditor may perform are reviewing information in the investor's files that relates to the investee such as investee minutes and budgets and cash flows information about the investee and making inquiries of investor management about the investee's financial results.
>
> If the investee's financial statements are not audited, or if the investee auditor's report is not satisfactory to the investor's auditor for this purpose,

[1] In determining whether the report of another auditor is satisfactory for this purpose, the auditor may consider performing procedures such as making inquiries as to the professional reputation and standing of the other auditor, visiting the other auditor and discussing audit procedures followed and the results thereof, and reviewing the audit program and/or working papers of the other auditor.

the investor's auditor should apply or should request that the investor arrange with the investee to have another auditor apply, appropriate auditing procedures to such financial statements, considering the materiality of the investment in relation to the financial statements of the investor.

Although investor entities may share the same year end as the alternative investment, the timing of the investor entity's audit may be such that audited financial statements of the alternative investments are not available before the investor entity's audited financial statements are issued. In addition to the guidance provided in AU section 332, paragraphs .28 through .30, the auditor may consider the procedures articulated in the fair value section of this document in order to obtain sufficient appropriate audit evidence with respect to the valuation assertion under the equity method of accounting.

Management Representations

The auditor is required to obtain written representations from management as part of an audit of financial statements in accordance with generally accepted auditing standards. In connection with this requirement, the auditor ordinarily would obtain appropriate written representations related to alternative investments. The auditor may consider obtaining representations regarding the following:

- Appropriateness of the measurement methods and consistency in the application of the methods
- Completeness and adequacy of the disclosures related to estimated fair value information
- Subsequent events requiring adjustment to the estimated fair value measurements and disclosures.

AU section 328 suggests a number of items to be included in the management representation letter valuation assertion related to fair value estimates. The auditor ordinarily considers the following:

- The reasonableness of significant assumptions
- Whether the assumptions appropriately reflect management's intent and ability to carry out specific courses of action

Management representations are part of the audit evidence that the auditor obtains, but they are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit.

Disclosure of Certain Significant Risks and Uncertainties

With respect to alternative investments, the use of estimates to value securities may be an uncertainty as contemplated by Statement of Position No. 94-6, *Disclosure of Certain Significant Risks and Uncertainties*. In addition to other GAAP disclosures regarding investments and contingencies, SOP 94-6 provides guidance on the disclosures of risks and uncertainties regarding certain significant estimates used in the preparation of financial statements.

If the auditor concludes that a matter involving a risk or uncertainty is not adequately disclosed in the financial statements in conformity with GAAP, the auditor would express a qualified or adverse opinion (AU section 508.46).

Reporting

Emphasis of a Matter Paragraph

The more complex or illiquid the underlying investments are, the greater the inherent uncertainty in management's estimated fair value. 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 such as the following, tailored for the specific facts and circumstances:

> As explained in note X, the financial statements include investments valued at $ _______ (____ percent of net assets), 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.

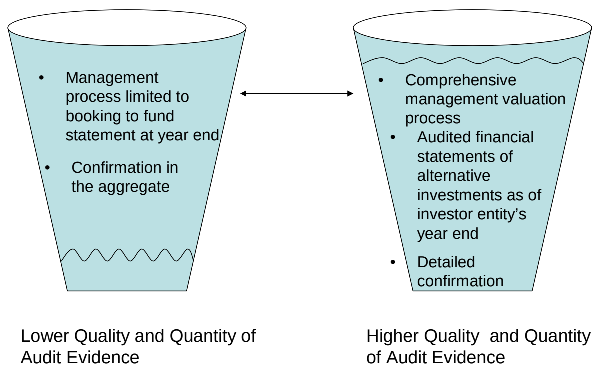
An emphasis of matter paragraph is not used to introduce information to the financial statements and neither replaces any required financial statement note disclosure nor reduces the required audit evidence needed to support an unqualified opinion. Such paragraphs are never required and are included solely at the auditor's discretion. The above emphasis of matter paragraph would be consistent with GAAP disclosures made in the financial statements.

Modifications to the Auditor's Report

The auditor's objective is to obtain sufficient appropriate audit evidence to provide a reasonable basis for forming an opinion. There are often significant challenges to management obtaining sufficient information to support its assertions relevant to alternative investments, and auditors will face similar challenges in obtaining audit evidence and evaluating its sufficiency. The amounts and types of audit evidence necessary to support an opinion are matters for the auditor to determine in the exercise of his or her professional judgment, after careful study of the particular circumstances. Exhibit 2, "Evaluation of Sufficiency and Appropriateness of Audit Evidence," illustrates the auditor's consideration of the sufficiency and appropriateness of audit evidence to support the auditor's conclusion that he or she has obtained sufficient appropriate audit evidence in order to provide reasonable assurance that the financial statements are free of material misstatement.

Exhibit 2

Evaluation of Sufficiency and Appropriateness of Audit Evidence



In evaluating audit evidence, the auditor considers whether the specific audit objectives have been met. The consideration might include such factors as:

- The significance of the alternative investments for which neither the underlying detail nor audited financial statements was available as of the balance sheet date
- The adequacy of management's process and related internal control
- Timeliness of the estimated fair value of the underlying investments

The auditor's justification for the expression of his or her opinion rests on the conformity of the audit with generally accepted auditing standards. When a *significant* amount of securities are stated at "estimated fair value," the auditor considers both the uncertainties inherent in the investment valuations and the extent of audit evidence supporting those valuations. The assessment of reasonableness of valuations considers their effects on the financial statements taken as a whole, not solely the investment caption in the financial statements. If the auditor is unable to obtain sufficient appropriate audit evidence to support the financial statement assertions, it will be necessary to qualify or disclaim an opinion on the financial statements due to a scope limitation.

AU section 508, paragraphs .22 through .26, provides guidance to the auditor in determining the appropriate form of opinion.

Scope limitations related to sufficiency of evidence are different from situations in which the auditor concludes that the financial statements are materially misstated due to departures from GAAP 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. If the potential effect of the GAAP departure is material to the investor entity's financial statements taken as a whole, the auditor issues a qualified opinion or an adverse opinion as described in AU section 508, paragraphs .35 through .49.

Appendix 1

EXAMPLE CONFIRMATION FOR ALTERNATIVE INVESTMENTS

{CLIENT LETTERHEAD}

{FUND ADDRESSEE NAME AND ADDRESS}

{DATE}

Dear {NAME}:

Our auditor, {NAME OF ACCOUNTING FIRM}, has been engaged to audit the financial statements of {CLIENT NAME} as of {end of client fiscal period}, and for the year then ended. In connection therewith, please complete the attached confirmation related to the {CLIENT NAME} investment in {INVESTEE FUND NAME} and return it along with any other requested information as delineated below to our auditor no later than {DATE}.

All correspondence with our auditors should be faxed to {NAME} at {FAX NUMBER} and then mailed directly to {NAME OF ACCOUNTING FIRM}, {ACCOUNTING FIRM ADDRESS}. A pre-addressed, postage paid envelope is enclosed for your use.

If you have any questions regarding this request, please contact me at {PHONE NUMBER}. We greatly appreciate your cooperation with our auditors and, specifically, your assistance with this confirmation.

Sincerely,

{CLIENT SIGNATURE}

{NAME}
{TITLE}

Please provide the following information for {CLIENT NAME}'s investment in {INVESTEE FUND NAME} as of and for the year ended {FISCAL YEAR END OF THE CLIENT}.

Capital Balance:

1 Balance as of {beginning of client fiscal period or initial investment date if later} ____________________

Contributions ____________________

Withdrawals ____________________

Management fees charged ____________________

Incentive allocation/fees charged or to be allocated ____________________

Net income after allocation and fees ____________________

Balance as of {end of client fiscal period} ____________________

2 Valuation date for capital account balance{end of client fiscal period}, if other date used then please indicate date: __/__/____ ____________________

3 Class of shares/units held ____________________

4 Ownership interest as a percent of fund net assets{end of client fiscal period}:

____

5 Allocated appreciation that is attributable to "New Issues," as defined by the NASD under its Free-Riding and Withholding Interpretation[2]:

____

6 Date of most recent partnership agreement, as amended: ____________________

7 Date of any additional or side letter agreements, if any ____________________

8 Please provide our auditors with a detail list of the investment holdings as of {end of client fiscal period}, including value of each underlying investment and ownership percentage [the fund's ownership of the underlying]

9 Basis of accounting used to complete this confirmation (please circle one):

US GAAP (Fair Value) Tax Basis Other; please describe

[2] This item generally would only be appropriate for a confirmation prepared by the auditor of a fund of fund

****

PREPARED BY:

____
Signature

____
Printed Name

____
Title

____
Date

Appendix 2

Illustrative Examples of Due Diligence, Ongoing Monitoring, and Financial Reporting Controls

Management's controls related to alternative investments would include procedures for *initial due diligence (that is, procedures performed before the initial investment), ongoing monitoring (that is, procedures performed post-investment), and financial reporting*.

Initial Due Diligence

- Conduct face-to-face meetings with the investment firm's management team

- Conduct on-site visit(s), including back office and operational due diligence

- Evaluate investment strategy, process and portfolio
  - Review historical performance and attribution analysis (audited, if possible)
  - Review valuation procedures

- Request documents review by investment staff
  - Offering memorandum
  - Legal agreements
  - Pitch books
  - Information requests
  - Financial statements
  - Form ADV (used by advisers to register with SEC as investment advisers)

- Evaluate how the specific allocation fits within the asset class and the overall portfolio

- Solicit information regarding the team/firm from knowledgeable third parties
  - Inform investment committee members that a manager is under consideration and request their input if they know the manager
  - Consultants
  - Competing investment managers

- Perform reference checks
  - Other investors
  - Investee companies
  - Service providers
  - Prior employers

- Perform third-party background checks on senior professionals
  - Verify biographical information
  - Perform criminal background search
  - Perform press search

- Review and negotiate legal agreements

- Complete a formal investment memorandum/write up or other investment approval review

Ongoing Monitoring

- Conduct regular in person or telephonic meetings with the investment firm management team

- Conduct on-site visit, typically done on an annual basis (often substitute with attending annual meeting)[3]

- Review fund communications
  - Review fund communications including quarterly shareholder's letters, etc.
  - Obtain and review audited financial statements, note whether the opinion is qualified, any change in the auditor, change in valuation procedures
  - For drawdown funds, compare partners' capital statements with internal transaction records

- Review SAS 70 reports if available, and ensure that identified user controls are in place at the investor entity

- Perform valuation
  - Request and review, if available, the valuation of portfolio holdings for reasonableness
  - For custodial assets, reconcile with custodian's pricing
  - Request and review any changes to valuation policies and procedures
  - For hedge funds, receive estimated value from fund and final value from fund administrator; compare for reasonableness
  - Compare the institution's statement of value received as of the fund's year end to the value based on the fund's audited financial statements and follow up on significant discrepancies

[3] Many institutions delegate this function to the a third-party investment adviser or consultant.

- Monitor portfolio performance
  - Compare performance to benchmark and expected returns if appropriate
  - Compare performance to publicly available data (for example, public sector indices for hedge funds)
  - Compare cash returns to previously reported market values throughout the year
  - Inquire periodically as to the total long and short positions throughout the year (for hedge funds)
  - Review portfolio holdings on a regular basis
  - If the investment strategy changes from the original investment approach, conduct comprehensive review of manager/team/strategy

- Monitor firm/manager
  - Review press reports for significant management/structure/personnel/portfolio developments[4]
  - Obtain and review Form ADV
  - Monitor staffing levels, personnel changes
  - Monitor size of assets under management in the strategy and firm wide

Financial Reporting

- Maintain a formal investment policy approved by the board of directors (or similar board that governs overall strategy, risks, authorized transactions, etc.)
- Have an investment committee of the board that is responsible for oversight of all investments and compliance with formal investment policy
- Continuously update a detailed listing of alternative investments grouped by fund or manager
- Review the most recent audited financial statement of each fund, noting basis of accounting, summary of significant accounting policies and procedures pertaining to the valuation of alternative investments, name of audit firm, and type of opinion
- Compare investment balances reported by fund manager to the general ledger
- Monitor the level of the ownership of the fund to determine proper accounting method (for certain types of investor entities)
- Perform and document an assessment of the risk of material misstatement of the financial statements related to the valuation of alternative investments

[4] Often includes search for damaging information on NASD or SEC sites

HAMMOND ASSOCIATES

Hedge Fund Manager Pricing Due Diligence

Hedge fund manager pricing issues represent an important step in our due diligence process. As part of our initial due diligence, we examine the manager's pricing policy. Typically, the manager will have a formal, well-defined process for valuation, which is often detailed in the offering materials. We confirm the existence of a pricing policy, assess its appropriateness, verify the administrator/auditor relationships, and review prior audited financials. While pricing issues are manager specific, following are generalizations that apply to most hedge funds:

The Net Asset Value of most hedge funds is calculated by the administrator, typically a recognized third-party. This responsibility is defined in the offering materials:

> *"…the Administrator is responsible for, among other things:…computing and disseminating the Net Asset Value of the Shares in accordance with the Articles of Association of the Fund…"*

Exchange-traded securities, which generally represent the majority of diversified hedge fund programs, are systematically priced from recognized, third-party quotation services.

> *"Securities which are listed on one or more United States or non-U.S. securities exchanges…are valued at their official closing price or their last reported sales price on the exchange on which such securities are principally traded on the date of determination, or, if no sale occurred on such day, at the mean between the "bid" and "ask" prices on such day."*

The pricing of illiquid securities requires greater scrutiny. Following is a typical pricing policy for illiquid investments:

> *"If the securities to be valued constitute a block which, in the judgment of the General Partner, could not be liquidated in a reasonable time without depressing or inflating the market, such block may then be valued by the General Partner; provided that such block shall not be valued at a unit value in excess of, for long positions, or below, for short positions, the quoted market price of such security.*
>
> ***Private Convertible Securities*** *where underlying common is publicly traded – We use the (Sample Manager) convert model using what we believe to be conservative assumptions in arriving at a value for the securities.*
>
> ***Restricted common stock*** *– Use the lower of cost or the market until the stock is registered and freely tradable, after that we use the market price.*
>
> ***Warrants*** *– We use a Black Scholes model with conservative volatility assumptions to arrive at a valuation for the warrant. We then adjust as follows: If the strike on the warrant is above the current stock price (i.e. out of the money) we use 50% of the Black Scholes value; If the strike is below the current stock price we value the warrant at intrinsic value plus one-half the premium per Black Scholes.*
>
> ***Private Equity*** *– We use the lower of our cost or the last financial transaction that would value the entity. For situations that we believe to be impaired we will write down the position even without a recent financial transaction."*

In some cases, managers periodically send information to auditors both for the purpose of establishing an accurate value to transact partnership flows and to facilitate timely disbursements of annual audits to investors. This "spot check" of pricing is reflected in the reported performance. We also use quantitative and qualitative "reasonableness" tests in assessing monthly returns versus our expectations given the market environment for the strategy for the given time period.

As a part of our continuous due diligence, we review the annual audits for qualified opinions or other anomalies that may catch our attention. Typically, the annual audit will contain an opinion statement similar to the following:

> *"In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of (Sample Fund Ltd) and Subsidiaries as of December 31, 2005, and the results of its operations, changes in its net assets, and its cash flows for the year then ended, in conformity with the accounting principles generally accepted in the United States of America."*

Our manager auditors are generally well respected, well known firms. Audited financials often display any position over 5% and may aggregate investments in various categories. For example, bank debt, trade claims, common stocks, convertible bonds, government bonds, and warrants may be included in consolidated financials. The category breakdown in audited financials helps us assess the portfolio characteristics in relationship to the manager's defined investment strategy.

Obtaining a formal pricing policy and verifying through auditors the policy is maintained, allows us to remain informed about the valuation of our hedge fund portfolios. It's beyond the scope of our team to fully audit all our managers, so in part we rely on professionals performing their duties reliably, sufficiently, and with integrity. We continue to assess pricing policy throughout the investment horizon through communication with manager and auditor, and reviewing audited material
.