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WEALTH ADVISORY | OUTSOURCING | AUDIT, TAX, AND CONSULTING

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Alternative Investments: Audit Perspectives

Learning Objectives

- Identify types of alternative investments
- Recognize the appropriate completion of risk assessment analysis
- Recognize required financial statement disclosures





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**What are Alternative
Investments?**

Investopedia.com

- An *alternative investment* is an asset that is not one of the conventional *investment* types, such as stocks, bonds and cash. Most *alternative investment* assets are held by institutional investors or accredited, high-net-worth individuals because of the complex natures and limited regulations of the *investments*

Alternative Investments

- What are they?
 - Private funds
 - ◇ Specific objectives
 - ◇ Limited ownership group/investors
 - Do not have readily determinable fair values
 - ◇ Assets not listed on any national exchanges or markets for which quoted market prices are not available from sources such as financial publications or exchanges



Alternative Investments *(continued)*

- Generally not very liquid, have redemption restrictions
- Clients invest in to achieve a higher rate of return, diversify portfolios and obtain certain objectives (e.g. hedge strategy)
- Generally higher level of risk

Alternative Investments

- Types
 - Collective trust funds (CCT)
 - Pooled separate accounts (PSA)
 - Private equity funds (LLC, LLP)
 - Real estate funds and REITs
 - Hedge funds
 - Real assets (mineral rights, timber, etc.)
 - Any other oddball, limited type of investment that investment managers can come up with

CCT and PSA

- Commingled or pooled funds that look like mutual funds
- Generally run by insurance companies
- Not registered with the SEC
- Frequently invested in mutual fund or marketable securities
- Look for:
 - Trust document / insurance contract
 - Words such as “common”, “collective”, or “pooled”



Private Equity Funds

- Venture capital, limited partnerships, or other start-ups
- Evidenced by written agreement which allows for call commitments and withdrawal restrictions
- Generally illiquid due to nature of assets they invest in
- Look for:
 - Subscription agreement
 - Investment management agreement
 - Words such as “partner”, “LP”, or “LLC”
 - K-1



Real Estate Funds/REITs/Real Assets

- Invest in real estate ventures or real assets
- Investment structure can be LP or LLC that typically involves direct purchases of real estate property
- REIT = Real estate investment trust
- Generally illiquid due to underlying securities/assets
- Look for:
 - Subscription agreement
 - Investment management agreement
 - Trust agreement
 - Words such as “real estate”



Hedge Funds

- Use aggressive strategies including selling short and extensive use of derivatives; used for leveraging
- Offshore investments
- Look for:
 - Subscription agreement
 - Investment management agreement
 - Words such as “offshore” or entities outside of U.S. or “derivative”
 - General partner – limited partner relationships
 - Master fund – limited fund
 - Fund of funds



How to Identify

- Review of bank statements
 - Some banks identify investments they do not custody with a specific mark (i.e. **)
- Security name: look for key words previously identified
- Internet search: can you Google the investment?
- Discuss with the investment manager or investment consultant
- Discuss with custodial bank on what managers they custody and price vs. not
- Assets under unique portfolio titles: miscellaneous, other assets, alternative strategies
- Review investment agreements
- Review audited financials



Examples

ASSETS	12/31/2013 MARKET VALUE
Cash And Equivalents	18,400,602.94
Domestic Common Stocks	112,845,238.26
Foreign Stocks	6,520,247.08
Mutual Funds-Equity	92,834,781.17
Miscellaneous	298,299,110.38
Total Assets	528,899,979.83
Accrued Income	195,734.10
Grand Total	529,095,713.93





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Audit Procedures for Alternative Investments

Audit Risks

- Existence
 - Do the assets actually exist?
 - Does Bernie Madoff mean anything to you?
- Valuation
 - Fund manger asserts valuation (vested interest)
 - How do you get comfortable
- Cut-off
 - Transactional risk within the fund
 - Valuation risk related to when valuation done

Audit Procedures – Similar Testing

- What alternative investment testing mirrors testing done of non-alternative investments?
 - Confirmations (existence)
 - Valuation testing (valuation, cut-off)
 - Income reasonableness; done in conjunction with investments as a whole (valuation, cut-off)



Audit Procedures – Additional Testing

- Testing done specifically on alternative investments
 - Review of investment assessment by governance
 - Roll Forward
 - Net asset value lookback schedule
 - Review of subscription agreements

Investment Assessment

- How is investment being monitored?
- Do those performing monitoring have the skills/ability?
 - Complexity of investment
 - Complexity of strategy
 - User of external investment advisors
- Investment manager performance
- Frequency and type of due diligence
- Who performs function?
 - Investment Committee
 - External Investment Consultant



Audit Procedures – Valuation Testing

- Audit team assesses the coverage desired on alternative investment testing during planning
- Funds chosen for testing are a combination of larger funds and risky funds to ensure adequate coverage on both complexity and the overall balance
- Funds chosen for testing may be rotated year over year depending on complexity and desired coverage
 - Large and complex funds may be tested each year
 - ◇ Dollar amount invested
 - ◇ Foreign currency denominated funds (e.g. Euro)
 - ◇ Numerous investment tranches



Audit Procedures – Valuation Testing *(continued)*

- Items needed for testing:
 - Audit report of fund
 - Ownership percentages
 - Client statement matching both fiscal year end and fund year-end
 - Investment benchmark related to each fund
 - Underlying subscription agreement
- The amount reported on the investment custodian report is normally the value at the previous quarter end
 - Custodians do not value – fund managers do
 - Values are normally not available until 60-90 days after the end of the quarter



Audit Report Review

- Make sure you have the correct fund statement
- Review audit opinion
 - Who issued? Do you know the firm?
 - Type of opinion
 - ◇ Auditing standards – US or International
 - ◇ Unmodified
 - ◇ Modified
 - Emphasis of matter paragraph included?
 - Unusual footnotes
 - ◇ Going concern
 - ◇ Concentrations
 - ◇ Commitments and contingencies

Testing - Rollforward

- Objective is to tie investment to the audited fund statements and perform a reasonableness test on the earnings from that point forward
- Compare the price per unit/share per the audited financial statements to the amount on the fund manager provided account statement at same year end
 - May be complicated by foreign currency translation and/or values of different tranches
- Mathematically extend the investment value using the price above and units/shares owned

Testing - Rollforward *(continued)*

- Add and subtract all cash activity for the period from the audit report date to the government's year-end
- Compare the result with the fund manager provided statement as of the same date
- Difference should be the investment income/loss during the period
- Perform a yield analysis for the period and compare to the fund benchmark
 - Benchmark should be found in the fund financial statements
 - ◇ May need to contact fund manger
 - Should be reasonably close



Audit Procedures – Net Asset Value Lookback Schedule

- Should be completed at interim or at the beginning of an audit
- Meant to show which investments/funds have adjustments from their preliminary year-end balances to their audited balances
- Provides credibility to statements managers receives during the year
- Provides insight into which investments might be more risky than others due to late adjustments made by the funds
- Can provide support for the audit team to issue an audit in advance of final audit reports where there no variances between preliminary vs. final numbers





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Disclosures for Alternative Investments

Audit Procedures – Required Disclosures

- Portfolio note showing entire investment portfolio
- Level hierarchy footnote
- Net asset value table
- Net asset value commentary based on how valuation is determined, including discussion of unobservable inputs



Required Disclosures – Portfolio Note

- Should equal the total investments shown on the balance sheet
- Should mirror clients investment policy structure
- Example footnote disclosure:

Cash and cash equivalents	\$	400,000
Fixed income		300,000
Global equity		500,000
Hedge funds		1,000,000
Natural resources		500,000
Real estate		250,000
Private equity		325,000
Total	\$	<u><u>3,275,000</u></u>



Required Disclosures – Level Note

- Should include only those assets and liabilities measured at fair value; cash/cash equivalents would be excluded
- Alternative investments are either Level 2 or 3
- Dependent upon ability to redeem investment at NAV in the near term at measurement date
 - Redemption period of 365 days or less generally considered near term, would equal level 2



Required Disclosures – Level Note

	Total	Fair Value Measurements		
		Level 1	Level 2	Level 3
Investments by fair value level				
Debt securities				
U.S. Treasury Securities	\$ 85	\$ 85	\$ -	\$ -
Commingled mortgage-backed securities	50	-	45	5
Collateralized mortgage obligations	30	-	5	25
Residential mortgage-backed securities	149	-	24	125
Corporate bonds	93	9	84	-
Total debt securities	407	94	158	155
Equity securities				
Financial services industry	150	150	-	-
Healthcare industry	110	110	-	-
Other	15	15	-	-
Total equity securities	275	275	-	-
Venture Capital investments	85	-	-	85
Private equity securities - international	43	-	-	43
Total investments by fair value level	810	369	158	283
Investments measured at net asset value (NAV)				
Equity hedge funds	55			
Event-driven hedge funds	45			
Global opportunities hedge funds	35			
Multi-strategy hedge funds	40			
Real estate funds	47			
Total investments measured at the NAV	222			
Total investments measured at fair value	\$ 1,032			



Required Disclosures – Net Asset Value Table

- Required disclosures (by major class) for non-readily marketable investments valued at NAV or equivalent
 - Fair value as of report date
 - Unfunded commitments
 - Redemption frequency
 - Redemption notice period
 - Restrictions on withdrawal (if any)
 - Investment objective



Required Disclosures – Net Asset Value Table

- How to test disclosure?
 - Confirm with investment manager
 - Review investment agreement
 - Review audited financial statements
 - Review custodial statements



Required Disclosures – Net Asset Value Table

	Fair Value	Unfunded Commitment s	Redemption	
			Frequency (If Currently Eligible)	Notice Period
Equity hedge funds	\$ 55	-	Quarterly	30-60 days
Event-driven hedge funds	45	-	Quarterly, annually	30-60 days
Global opportunities hedge funds	35	-	Quarterly	30-60 days
Multi-strategy hedge funds	40	-	Quarterly	30-45 days
Real estate funds	<u>47</u>	20	Quarterly	30-60 days
Total investments measured at the NAV	\$ <u><u>222</u></u>			



Required Disclosures – Net Asset Value Narratives

- Should have a paragraph on each category of investments listed within the NAV table
- Example:
 - (a) Hedge Funds – this category includes investments in hedge funds that invest in equity, debt, structured products, and derivative securities. The managers of these funds have the flexibility to change their exposure based on their view of particular securities and the overall market. The strategies of these funds include event-driven, relative value, arbitrage, and directional strategies. The fair values of these investments have been estimated using the net asset value per share of the investments.
 - (b) Natural Resources – this category includes direct investments in natural resource related firms, generally through limited partnerships, that invest in private companies. The fair value of these investments has been estimated using the percentage share of the Foundation’s ownership interest in partner’s capital. Distributions from each fund are received when the underlying investments in the funds create distributable cash flow and when underlying investments are liquidated.



Required Governmental Disclosures (GASB)

- GASB 72 – Fair Value Measurement and Application
 - Differences between ASC 820 and GASB 72 include:
 - ◇ Investments valued at Net Asset Value (NAV) should not be included in the leveling table under GASB 72. These investments should only be separately displayed in the table for investments valued at NAV



Required Governmental Disclosures (GASB)

- Fees – Gross vs. net fees
 - GASB 67 para. 26
 - ◇ “Investment-related costs should be reported as investment expense if they are separable from (a) investment income and (b) the administrative expense of the pension plan”
 - Need to delineate the policy for reporting investment fees
 - ◇ Fees paid directly to investment managers
 - ◇ Fees deducted from the NAV or included with capital calls
 - Consider disclosing policy for reporting fees
 - ◇ Particularly in the supplementary information schedule of investment expenses required by GFOA in pension CAFR’s



Resources

- AICPA Alternative Investment guidance (within the A&A nonprofit and accounting guide)
- CLA Financial: for review of benchmarks
- Hedge Fund Research Inc.
 - Can sign up for monthly emails that have wide variety of hedge fund type returns
- Template created by the Institutional Limited Partners Association (ILPA) assists with gathering fee information for alternatives.





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