

Case 10-8

Ellie Enterprises

An engagement team is in the process of planning the audit of Ellie Enterprises Inc.'s (Ellie) financial statements as of, and for the year ended, December 31, 2012, under audit standards established by the AICPA.

Ellie sponsors a defined benefit pension plan that it accounts for under ASC 715-30, *Compensation — Retirement Benefits: Defined Benefit Plans — Pension*.

Along with planning the audit, the engagement team is in the process of understanding the entity's pension plan investment management process in order to assess risk and design further audit procedures.

The following information has been obtained:

- Ellie's plan assets are held in a trust with Union Gigantic Bank (Union), which acts as trustee and custodian for the underlying assets.
- Ellie's Retirement Plan Committee (the Committee) maintains a formal investment policy, which has been approved by the Board of Directors.
- On the basis of the guidance provided by the Committee, Union structures the plan's asset allocation strategy. The Committee periodically reviews plan performance and asset allocation, and makes adjustments on a quarterly basis. The current target asset allocation is 50 percent equity, 20 percent fixed income, 15 percent with high-yielding hedge funds, and 15 percent in real estate funds.
- Given targeted allocation percentages, investments are held in five separate funds. The funds are managed by Cloudy Investments, which is not associated with Union.
- Three of the funds (Cloudy Retirement 500 Index, Cloudy High-Yield Hedge Strategies, and Cloudy Real Estate All Stars) are private-investment vehicles that are not registered under the Investment Company Act of 1940 or under the Securities Act of 1933.
- Two of the funds (Cloudy Retirement Emerging Markets Stock Index and Cloudy Retirement Intermediate-Term U.S. Treasury) are registered with the SEC under the Investment Company Act of 1940 and under the Securities Act of 1933.
- A snapshot of each fund, including its holdings and investment strategy, is provided below.
 - *Cloudy Retirement 500 Index*: Managed to track the S&P 500 Index. Portfolio includes approximately 500 publicly traded domestic equity holdings.

- *Cloudy High-Yield Hedge Strategies*: Invests in 10 high-yield hedge funds that seek to maximize returns. Holdings of the underlying hedge funds consist of public and private stocks that are expected to significantly outperform the market and include investments in start-up technology and social media companies. The funds use leverage and derivative instruments to maximize their returns.
- *Cloudy Real Estate All Stars*: Invested primarily in high-quality real estate properties, but may invest up to 20 percent in publicly traded real estate funds, treasuries, and other government securities. The fund is managed to outperform the National Council of Real Estate Investment Fiduciaries (NCREIF) Property Index Returns Index. The underlying properties are located in the 25 largest U.S. cities, and 65 percent of the tenants have credit ratings between A and AAA grades. The portfolio includes approximately 30 properties.
- *Cloudy Retirement Emerging Markets Stock Index*: Managed to track the Morgan Stanley Capital International (MSCI) Emerging Markets Index. Portfolio includes approximately 700 publicly traded domestic and foreign-equity holdings.
- *Cloudy Retirement Intermediate-Term U.S. Treasury*: Invested in treasury (85 percent) and government agency bonds. Portfolio includes approximately 50 U.S. government bond holdings.
- For financial reporting purposes, management uses each respective fund's net asset value per share (NAV) and shares held (both figures provided by Union) to calculate the fair value of the investment.

Audit Procedures

The engagement team decided not to take control reliance.

A specific risk has not been identified related to investments.

Year-end audited financial statements for the funds are not available before the issuance date of the auditors' report on Ellie's consolidated financial statements.

At year-end, a confirmation was sent to Union. In response, on a fund-by-fund basis, Union provided the shares held, NAV, and total outstanding shares. All investment fund balances are considered material to the financial statements. An excerpt of the information is included in the following table:

Relevant excerpts from the confirmation replies received directly from Union:				
Fund	Shares Held by Ellie	NAV	Balance Ellie	Total Outstanding Shares
Cloudy Retirement 500 Index	45,388	\$132.41	\$6,009,825	907,718
Cloudy High-Yield Hedge Strategies	117,647	\$25.79	\$3,034, 116	2,426,830
Cloudy Real Estate All Stars	262,897	\$9.15	\$2,405,508	3,755,671
Cloudy Retirement Emerging Markets Stock Index	134,388	\$25.51	\$3,428,238	1,919,829
Cloudy Retirement Intermediate-Term U.S. Treasury	366,268	\$10.80	\$3,955,694	44,391,745

Required:

- Would any of these funds be considered alternative investments (i.e., investments without readily determinable fair value)? If so, why? (Alternative investments are generally defined as investment vehicles (1) that are not listed on national exchanges or over-the-counter markets or (2) for which quoted market prices are not available.)
- Do the confirmations provide sufficient competent audit evidence to support the existence of the investments? Discuss what additional procedures, if any, may be necessary and why.
- Do the confirmations provide sufficient competent audit evidence to support the valuation of the investments? Discuss what additional audit procedures, if any, may be necessary for the following investments:
 1. Cloudy Retirement Intermediate-Term U.S. Treasury.
 2. Cloudy High-Yield Hedge Strategies, assuming:
 - a. The audit team received a detailed confirmation of the underlying investments.
 - b. The audit team did not receive a detailed confirmation of the underlying investments.