Case 10-9

Institutional Investor Company

Institutional Investor Company (IIC) is a for-profit conglomerate consisting of multiple business lines operating in a variety of industries throughout the United States. IIC is being audited under audit standards established by the AICPA.

IIC is highly profitable and manages an investment portfolio of approximately $500 million that is used to fund operations as needed. The investment portfolio represents 15 percent of IIC's consolidated total assets. For the past several years, IIC has managed its investment portfolio in a conservative manner, investing primarily in equity securities within the Standard & Poor's (S&P) 500 Index and in investment grade bonds (i.e., bonds with a rating of BBB or above, or equivalent quality rating). However, management is unsatisfied with the historical returns on IIC's investment portfolio and therefore is looking to diversify by investing a portion of the portfolio in alternative investments, which seem to promise higher returns. (Alternative investments represent investment vehicles that are not listed on national exchanges or over-the-counter markets, or for which quoted market prices are not available; e.g., hedge funds, real estate funds, and private equity funds.) While management has been monitoring developments in the investment industry and is concerned with the additional risk, it believes the risk can be managed and, therefore, has decided to move forward with the plan. Currently, management anticipates that up to $100 million (or 20 percent of the investment portfolio) will eventually be invested in alternative investments. The investment amount is considered material to IIC's financial statements.

Management anticipates that it will use at least two different fund managers to manage IIC's alternative investments. Management is currently considering several potential fund managers. In addition, management intends to use its current third-party record keeper's expertise to perform certain investment valuations.

Before finalizing and implementing the plan, management will need approval from the Board of Directors (the Board). The Board has requested that management prepare documentation that will facilitate its understanding of the risks involved and, equally important, what controls management intends to implement, both pre-investment and post-investment, to manage the risk and provide reasonable assurance that financial statements are prepared accurately.

In connection with management's preparation for the upcoming Board meeting, the Board outlined a controls process and is seeking consultation about whether any additional control procedures should be included.

The following is an excerpt of information that management has prepared for the Board detailing processes and controls that management is planning to implement.

Procedures to Evaluate and Mitigate Risk of Initial Investment (Initial Due Diligence)

- Conduct meetings with the prospective manager's investment team.
  - In the meetings, include a broad discussion on the investment manager's strategies, funds, performance, asset allocation, investment risks, and procedures, including the valuation method and tax implications, frequency and timeliness of fund information (such as details of the portfolio and underlying pricing), restrictions on withdrawal (if any), and the investment-related fee structure.
  - Request legal documents (e.g., legal agreements, offering memorandum, Form ADV, client proposal) and quantitative analysis.
- Evaluate each prospective manager's strategy, process, and portfolio, including historical performance, and determine how the specific allocation fits within IIC's asset class and overall portfolio investment strategy.
- Make a recommendation, documented in a formal memorandum, which is sent to the Board for approval.

Procedures to Monitor Investments

- Conduct recurring meetings with the investment firm management team, including a minimum of one on-site visit per year.
- Review fund communications in a timely manner (e.g., financial results) for reasonableness and consistency with applicable benchmarks as well as consistency with the overall investment strategy and asset allocations and risks described in the offering document.

Controls Over the Financial Reporting and Valuation of Investments

- Revise formal investment policy to reflect inclusion of alternative investments.
- Board review to verify that alternative investments transactions are in compliance with the policy.

Required:

- In initial due diligence, ongoing monitoring, and financial reporting and valuation, what additional controls or procedures (if any) should management consider?
- In anticipation of an initial public offering (IPO) early next year, management has assessed IIC's controls over the valuation of investments and believes the service auditor's report from the third-party pricing service provides adequate control coverage. As an SEC registrant required to perform an integrated audit in accordance with audit standards set by the PCAOB, management has asked if reliance on the service auditor's report will sufficiently demonstrate IIC's control

processes over the valuation of investments. If it does not, what additional controls or procedures should IIC consider implementing?