



Breaking the mold

Challenge of auditing
alternative investments



Over the past five years investors have developed an increased appetite for alternative investments, due largely to their desire and eagerness to achieve high returns with less vulnerability as to the market risk and high volatility associated with quoted stocks. Accordingly, regulators and auditors are acknowledging the risks associated with such non-traditional investments that present a challenge for both, the investor and the auditor alike.

Alternative investments are investments that do not belong to the three traditional asset types, namely stocks, bonds and cash. Due to their complex nature, limited regulations and relative lack of liquidity, most alternative investment assets are held by institutional investors or by experienced high net-worth individuals. Alternative investments include equities in private and real estate ventures as well as hedge funds. According to Bloomberg Briefs dated 24 January 2014, non-traditional investments assets under management now exceed US\$6 trillion globally. In particular, private equity firms were sitting on more than US\$1 trillion in available capital at the end of 2013, according to a recent report from Bain & Company.

Auditing interpretation on auditing alternative investments

In 2005 the American Institute of Certified Public Accountants (AICPA) issued an auditing interpretation on auditing alternative investments. In 2006 AICPA issued a practice aid which required auditors and management to respond to the existence and valuation assertions relating to alternative investments. The practice aid provides guidance not only to auditors, but also to management monitoring those investments as part of their operations.

With respect to the existence assertion, several questions arise such as: does the investor's entity investment exist as at financial statement date, and has the related transaction occurred during that period? Is there evidence and understanding of the underlying investments? Is it enough to obtain confirmation from general partners, fund managers, and third parties that a particular alternative investment exists?

The interpretation's response is clear: it states that confirmation by itself does not constitute adequate audit evidence but rather adds that once the existence risk is deemed significant, an auditor has to perform additional procedures such as observing management site visits, correspondence, inspecting fund agreements, reviewing periodical fund statements, and vouching certain cash receipts and disbursements, in addition to consider practicality of confirming the holdings of the alternative investments on a security-by-security basis.

As to the valuation assertion, one major question arises: is the alternative investment, measured at year-end, impartially at fair value? Companies often turn to their custodians to provide analysis and data about fair value by relying on the analysis and data provided by the general partners "GP" or the fund managers, though recently there has been an increasing shift away from this reliance on custodian statements, which are thought not to provide a reasonable estimate given the amount of information the custodians themselves might lack. Accordingly, and given such an inherent limitation in the custodian's role with respect to such complex types of unquoted multi-level investments, it would be insufficient for a custodian to ascertain whether the alternative asset price received from the fund manager is a fair price. Confirming the value from third parties provides one piece of evidence, yet the practice aid clearly states that additional evidence is obtained through initially inquiring about the valuation procedures applied by management, comparing unaudited net asset values – received by the investor entity at year-end – to audited financial statements, tracking the timeliness of net assets values provided by the investee company manager during the year, obtain the K-1 Schedule (in case of U.S.-based investments) and review any federal and state tax liability, compare net asset value by the investee company fund with the net asset value as per the custodian.

Client management vs. auditor

Given the above, monitoring the existence and valuations of alternative investments is initially the responsibility of management, and therefore management must have the proper control environment in place and have adequate understanding of its investments. Such an understanding

Non-traditional investments assets under management may have exceeded US\$6 trillion globally

is obtained through initial due diligence performed before the investment, ongoing monitoring, and financial reporting controls relating to the accounting for, and reporting of, the investment.

It's always worth reminding ourselves that the auditor cannot audit what management has not accounted for. Accordingly the design and implementation of the internal control environment are critical because the nature, timing and extent of audit procedures are determined based on them. An important element in determining the nature, timing and extent of audit procedures is the auditor's understanding of the reliability process that the investor's management uses to determine estimated fair value. In cases where the auditor is unable to audit the existence or valuation assertions of alternative investments as at the financial statement date, the auditor should assess based on circumstances and significance whether that would trigger a scope limitation or disclaimer of opinion. Additionally, management representations relating to the appropriateness of the measurement methods and consistency in application of valuation methods, completeness and adequacy of the fair value disclosures, subsequent events affecting fair value measurements etc... do not represent a comfort zone to the auditors in respect of entities with complex and sophisticated alternative investments. Simply because these representations are beyond management's capacity or ability to capture given their complexities and therefore we expect these representations to be uncertain at times. Accordingly, relying too much on these representations does not actually improve the quality of audits but rather might increase the risks surrounding it.

A plethora of challenges

Evidently, auditors will be facing many challenges while auditing such non-traditional types of financial instruments. To name a few:

1. From satisfying themselves that there is sufficient evidence to support the valuations used to whether or not it is sufficient to rely on a General Partner or Fund Manager valuation;

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2. Assessing the point at which the size of alternative investment portfolio that cannot be readily valued triggers a scope limitation;
3. Disclosing the material commitments along with their call date relating to these investments that are considered off-balance sheet commitments;
4. Obtaining full assurance in cases where the investor company is using the one-quarter lag method for valuation and therefore how are the auditors obtaining assurance on year-end valuations
5. Assessing the proper accounting treatment of distributions made by these investments and the basis of recognizing them as a return of invested capital (ROIC) or return on capital (ROC), meaning as a deduction of the invested cost or as income through profit or loss.

Conclusion

Going forward, institutional investors are likely to allocate a higher percentage of their portfolio to alternative investments, yet the intricacy, illiquidity and opacity that characterize the alternative sector makes it a daunting task to audit alternatives. As it seems to us when auditing an area as non-traditional as alternative investment, what is essential is more clarity in the guidance and base lesser reliance on judgment call on the part of the auditors.

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