

## New AICPA Practice Aid Provides Guidance to Hedge Fund Investors – Could this Affect You?

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In July 2006, a task force of the American Institute of Certified Public Accountants (AICPA) issued a Practice Aid entitled "Alternative Investments – Audit Considerations," which is intended to provide guidance to auditors of entities that invest in alternative investments. The Practice Aid applies to auditors of investors in alternative investments. Such investor entities may include colleges and universities, hospitals, non-profit organizations, pension plans, and funds of funds. The types of alternative investments covered by the Practice Aid include private investment funds such as hedge funds, private equity funds, real estate funds, venture capital funds, commodity funds, offshore fund vehicles, and funds of funds. Given the nature of these investments, it can sometimes be challenging for auditors to obtain sufficient audit evidence as to the existence and valuation of alternative investments recorded in an investor entity's financial statements. The Practice Aid provides guidance for auditors to consider regarding risk assessment and audit approach in order to obtain a sufficient level of comfort when asserting to the existence and valuation of alternative investments.

A typical audit procedure to verify existence is for the auditor to request a written confirmation, from the fund manager, of the investor entity's interest in the fund as of the balance sheet date. The Practice Aid provides an illustrative confirmation request. If the auditor is unable to obtain a confirmation then the guidance provides examples of alternative procedures such as reviewing governing documents of the investee fund, inspecting correspondence and account statements received from the investee fund and vouching relevant capital subscription or redemption activity. Determining what degree of evidence constitutes sufficient audit evidence is a matter of auditor judgment.

The Practice Aid devotes significant attention to the valuation of alternative investments. It emphasizes that management is responsible for making the fair value measurements and disclosures in the financial statements. The auditor's responsibility is to understand and

validate management's estimate of fair value. The Practice Aid contains guidance about the auditor's approach to obtaining an understanding of management's controls over their valuation process. It also contains an appendix which may be useful to certain investors that outlines examples of due diligence, ongoing monitoring and financial reporting controls for investor entity's management to consider related to alternative investments.

It would not be unusual for the fiscal year-end of a hedge fund investment to be different than the fiscal year-end of an investor entity. In such a situation, the auditor of the investor entity may not be able to place adequate reliance on the audit of the fund because it is as of a different date than the audited financial statements of the investor entity. The Practice Aid provides guidance to auditors of the investor entity on other additional procedures to consider in order to reconcile the different dates, including reliance on strong internal controls at the investor entity. If management of investor entities are unable to satisfy their auditors, then it is possible that conflicting fiscal year-ends could lead to qualified opinions due to a scope limitation on the financial statements of some investor entities.

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### How could MFA Members who are Fund Managers be Affected by this Guidance?

If your investors are institutions subject to financial statement audits, you may see an increase in the level of detailed information requested of you by the management of your investors and their auditors. The auditors of the institutional investor entity may be able to rely on the audit of the fund; however, as described above, if the audited balance sheet date of the institutional investor entity is different than the audited balance sheet date of the fund, then the fund manager may be requested to provide greater transparency of the value of the investments underlying the fund's net assets as of the investors balance sheet date.

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### How could MFA Members who Sponsor Funds of Funds be Affected by this Guidance?

The auditors of the financial statements of your sponsored fund of funds may request that you send more detailed confirmation requests to your investee fund managers. The auditors may also evaluate to what extent they could place some reliance on the internal controls of the fund of funds manager. For example, your auditor may make more in-depth inquiries as to the extent of initial due diligence and ongoing monitoring controls over your investments in other funds. Your auditor may also assess the adequacy of financial reporting controls over the proper accounting methods and valuation of your investments in other funds.

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### How could Investors in Funds Managed by MFA Members be Affected by this Guidance?

It is possible that the auditors of certain types of institutional investors such as college endowments, non-profit organizations, hospitals, pension plans, etc. may not be familiar with the typical auditing practices appli-

able to alternative investments. Their understanding and application of the concepts and recommended audit procedures described in the Practice Aid may result in additional audit steps and may require greater coordination among the management of the investors and the fund managers and their auditors. If the auditors are unable to satisfy themselves as to the existence and valuation of investments as of the institution's audited balance sheet date, then it could result in a qualified audit opinion on the financial statements of the institution, if the investments are material. It is possible that a qualified audit opinion on the financial statements of certain types of institutional investors could adversely affect an entity's fund raising ability (in the case of endowments or non-profit organizations for example) or could adversely affect its ability to meet the requirements of its regulators.

The AICPA Practice Aid is available on the AICPA's Web site [www.aicpa.org](http://www.aicpa.org). ©