

Weighing the Alternatives: Alternative Investments Bring Valuation, Financial Reporting Challenges

By Cynthia A. Pierce, CPA

Not-for-profit organizations looking for ways to turbocharge their portfolios are increasingly turning to alternative investments. These investments — which include hedge funds, private equity funds, venture capital funds and other vehicles — often deliver above-average returns, particularly in down markets. With these potential rewards, however, come increased risks, as well as new challenges and responsibilities for organizations and their auditors.

Growing Popularity

Over the past several years, alternative investments have grown in popularity among not-for-profits that are dissatisfied with the performance of traditional investments in publicly traded stocks and bonds. In a recent survey,¹ the National Association of College and University Business Officers reported that almost 30 percent of endowments (on a dollar-weighted-average basis) are held in investments other than equities, fixed income and cash.

For the wealthiest institutions — those with endowments that exceed \$1 billion — the figure is even higher, at almost 36 percent. Institutions with endowments of \$25 million or less invest just over 6 percent of their assets in alternative investments. Hedge funds are the most popular alternative, representing almost 15 percent of endowments (more than 20 percent for the wealthiest institutions).

Alternative investments are often structured as limited partnerships. The general partner's flexibility in managing fund assets is what gives these funds the potential to outperform traditional investments, even when market prices are declining. Hedge fund managers, for example, are permitted to invest in many different markets, to take advantage of leverage and derivative instruments, and to employ a variety of speculative strategies.

The Need for Enhanced Due Diligence

Alternative investments demand a higher level of due diligence than traditional investments, because they are not readily marketable nor are they regulated by the Securities and Exchange Commission or any other public entity.²

In addition to determining whether a particular fund is appropriate in light of an organization's risk profile, management should scrutinize the fund's performance history and investigate the investment manager's background and qualifications.

To the extent practical, management should also assess the fund's internal control over financial reporting and safeguarding of assets and financial data to ensure that its assets and data are secure, that transactions are reported accurately and that earnings are allocated properly among the limited partners. Such information may be available through a SAS 70 report on the internal controls of the fund, or through inquiries regarding the fund's audit findings in the form of management letter comments.



¹ 2004 NACUBO Endowment Study, published January 2005.

² Last December, the SEC adopted rules that will require many hedge fund managers to register as investment advisors by Feb. 1, 2006.



Advantage:nfp

Valuation Challenges

Generally accepted accounting principles (GAAP) require not-for-profit organizations to report investments at fair value on their financial statements. With publicly traded securities, that is easy enough — their market prices are published daily in the *Wall Street Journal* and other business

Most alternative investments are not publicly traded, so the organization and its auditors must look behind the numbers and assess the reliability of the underlying pricing methodology.

publications. But most alternative investments are not publicly traded, so the not-for-profit organization and its auditors must look behind the numbers and assess the reliability of the underlying pricing methodology.

A fund's annual audited financial statements are a good place to start, but it is also important to evaluate the methods used to value a fund's public and nonpublic components. While most funds are privately held limited partnerships, a fund's underlying holdings may include both publicly traded and nonpublicly traded investments.

An investment manager may value the public component by taking market values and applying a discount to reflect the relative illiquidity of limited partnership interests. Valuing the private component, however, requires more digging. The manager needs to analyze developments in the relevant markets and industry sectors and discuss valuation issues with fund managers.

There are a limited number of procedures auditors and management can employ to test the reasonableness of these values, including comparison with public benchmarks and third-party valuations. Management should discuss any significant variations between management's estimate and the fund's estimate with the general partner.

Timing is Everything

A key valuation concern is the possible "lag period" between a fund's year end and the not-for-profit's year end. If, for example, a fund's audited financial statements are prepared as of Dec. 31 and the organization's fiscal year ends Aug. 31, the organization and its auditors need to confirm that

changes during the eight-month lag period are reflected accurately.

The first step is to gauge the accuracy of the fund's internally calculated values by comparing last year's quarterly or monthly statements to audited values. If the figures are reasonably close, then more recent interim statements should be reliable.

Additional adjustments may be required to account for changes between the most recent statement date and the organization's year end. Suppose the fund in our example prepared a June 30 quarterly report. The organization would need to bring the June 30 values to Aug. 31 by adding new investments and subtracting distributions made during the period and making adjustments for any significant changes in valuation considering the nature of the fund's underlying investments and their volatility.

These timing challenges are often compounded by late or incomplete statements. Many hedge funds, for example, deliver monthly statements but provide no detail on the fund's positions in various investments.

The Value of Full Disclosure

Not-for-profits are required to make financial statement disclosures about their investment valuation policies and about the use of derivative financial instruments. An investment's footnote should list each type of investment, both traditional and alternative, along with estimated fair market values, outstanding derivative instruments and investment returns.

Because most not-for-profit organizations use their investment earnings to finance program activities, prospective donors and other financial statement users are keenly interested in the value and performance of these investments. For this reason, organizations should consider making additional, optional disclosures about alternative investments including:

- Details about the makeup of each alternative investment category;
- The amounts of any future commitments to alternative investments;
- Payout spending guidelines; and
- Restrictions on funds held in alternative investments (e.g., permanently restricted, temporarily restricted or unrestricted).

Due Diligence Pays Off

If your organization invests in alternative investments, thorough due diligence is critical both before and after you invest. On the front end, it is important to investigate a fund's investment strategy and track record to be sure that it fits with your organization's investment goals and risk tolerance.

On the back end, you need to value alternative investments carefully in order to satisfy your financial reporting obligations and to provide financial statement users with the information they need to evaluate your investment program.

Cynthia Pierce can be reached at 312.899.7019 or cpierce@crowechizek.com.

Q & A Corner: Questions From Clients

By Ken Keber, CPA

Question: The American Jobs Creation Act of 2004 has imposed new penalties for failure to file the Report of Foreign Bank and Financial Accounts (Form 90-22.1). Are tax-exempt organizations required to file this form?

Answer: Any individual who has signature authority over, or a financial interest in, a foreign financial account which exceeds \$10,000 at any time during a calendar year must file Form 90-22.1 This includes any U.S. resident who has ownership or control over an account in a foreign country including Canada, Mexico, the Caribbean or other countries.

U.S. citizens residing in a foreign country who have control over personal checking or savings accounts or the bank or investment accounts of their employers must also file the form. Examples are foreign study programs, exchange student programs, travel tours, foreign investment accounts and other programs which use foreign accounts to remit, disburse or invest funds.

Any individual who is a U.S. citizen with control or a financial interest in the account must file Form 90-22.1 by June 30 each year. The individual must also check the box on schedule B to report the foreign account on his or her annual U.S. individual income tax return.

Penalties for failure to file the form include (1) the greater of \$100,000 or 50 percent of the largest balance in the account for a willful failure to file the return or (2) up to \$10,000 for a nonwillful failure to file the return.

Tax-exempt organizations should determine whether individuals in their organizations administer financial accounts in foreign countries and ensure that the *Report of Foreign Bank and Financial Accounts* is filed by June 30 each year.

Question: In 2004, the IRS began a program to target tax-exempt organization compensation practices. What is the status of this project?

Answer: Although there are no current numbers available, the IRS has stated that at least 2,000 organizations will be contacted by Fall 2005. In fact, the IRS has already contacted organizations in the Midwest and the information being requested is detailed and considerable.

The information the IRS is requesting includes actual cash compensation, fringe benefits and noncash benefits such as automobiles, expense accounts, family travel, tickets to events, loans, lease arrangements and housing, as well as other forms of compensation. The purpose of the review is to determine whether the organization's officers, directors or other insiders have received excessive compensation and benefits.

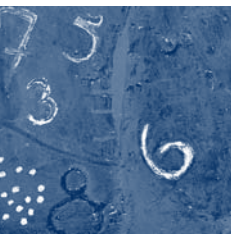
The IRS is also requesting procedures and documents that specify whether a separate compensation committee of the board reviews compensation and benefits and whether this committee considers comparative data for organizations of similar size located in the same geographic area when setting compensation levels.

Additionally, the IRS is scrutinizing whether all transactions with benefits provided to the specified individuals are being considered when setting compensation for directors, officers and other affected individuals.

Ken Keber can be reached at 574.239.7870 or kkeber@crowechizek.com.

Crowe Chizek and Company LLC
55 Campau Avenue, N.W., Suite 300
Grand Rapids, MI 49503

RETURN SERVICE REQUESTED



Advantage:nfp



Crowe's Not-for-Profit Services Group

A dedicated staff of professionals whose sole purpose is providing business solutions to not-for-profit organizations across the United States.

About Crowe

Under its core purpose of "Building Value with Values[®]," Crowe Chizek and Company LLC provides innovative business solutions in the areas of assurance, benefit plan services, financial advisory, forensic services, performance services, risk consulting, and tax consulting. Crowe Chizek, a Crowe Group LLP entity, was founded in 1942. One of the top 10 public accounting and consulting firms in the United States, Crowe also serves clients worldwide as a leading independent member of the Horwath International global professional services organization.

If you would like to start receiving information via e-mail about topics that are important to you, please sign up on our Web site at www.crowechizek.com/emailsingup.

Visit our Web site at www.crowechizek.com.

Contact:

Cynthia Pierce
312.899.7019
cpierce@crowechizek.com

Dennis Obyc
614.365.2907
dobyc@crowechizek.com

Laurie Haun
502.420.4482
lhaun@crowechizek.com

Scott Nickerson
317.706.2693
snickerson@crowechizek.com



Crowe Chizek and Company LLC is a member of Horwath International Association, a Swiss association (Horwath). Each member firm of Horwath is a separate and independent legal entity. Accountancy services in the state of California are rendered by Crowe Chizek and Company LLP, which is not a member of Horwath. This material is for informational purposes only and should not be construed as financial or legal advice. Please seek guidance specific to your organization from qualified advisors in your jurisdiction.
© 2005 Crowe Chizek and Company LLC