

Monitoring Alternative Investments
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ABSTRACT

In a turbulent and volatile investing market, the goal of accurately reflecting the value of alternative investments on a company's balance sheet has become increasingly more difficult. Alternative investments refer to securities that cannot be priced in a public market. Types of alternative investments include capital ventures, limited partnerships, hedge funds, etc. Emory University has a large endowment and the percentage of alternative investments to the total endowment has increased each year. Emory has an August 31st year end which poses valuation and confirmation issues. Auditors are concerned that the valuations are current and accurately reflect an August 31st value. Second quarter reports and valuations are not available from partnerships until August or September. The next "official" valuations for third quarter (September) are not available until the audit is nearing completion. This paper will provide a framework for monitoring the valuation of alternative investments throughout the year and recommend a practice for confirming a year end (August 31st) value.

INTRODUCTION OF THE ORGANIZATION

Emory University is an inquiry-driven, ethically engaged and diverse community whose members work collaboratively for positive transformation in the world through courageous leadership in teaching, research, scholarship, health care and social action. Located in Atlanta, GA, the University is recognized internationally for its outstanding liberal arts college, superb professional schools and one of the Southeast's leading health care systems.

The Controller's Office is an area of the Finance Division whose mission is to make Emory University fiscally fit by fostering integrity and excelling in competence and teamwork. To support this mission, the Finance Division embraces core values of Quality, Respect, Growth, and Courage. The goal is to provide meaningful information, achieve customer satisfaction, encourage ideas and opinions, build community relationships, and to promote continuous innovation and improvement. The vision of the Finance Division of Emory University is to provide quality service through people who are passionately committed to the success of Emory University.

STATEMENT OF THE PROBLEM/INITIATIVE

The alternative investments of Emory University's Pooled Investments have grown to account for the largest category in its asset allocation. These investments include capital venture, limited partnerships, hedge funds, oil and gas partnerships, real estate ventures, and timber ventures. The inherent problem in valuing this category of assets for an August 31st year end has prompted closer scrutiny by the external financial auditors. The Controller's Office set as a goal for fiscal year 2008 to improve the monitoring of all alternative investments.

DESIGN

The first step Emory took in accomplishing its goal of improving the monitoring of alternative investments was to dedicate an analyst in the Controller's Office whose to design and implement the process. The analyst began her task by examining the recommendations of the external auditor from the fiscal year 2007 audit. She also researched other institutions and their methods of monitoring these investments. After consideration of the auditor's recommendations and other research, several tasks were developed and implemented.

IMPLEMENTATION

Close communication between the Emory Controller's Office and Emory Investment Management (EIM) was critical to the process of monitoring alternative investments. The two offices are in separate locations, so a shared drive on the Emory network was set up to place documents needed by both departments. Access to the shared drive is very limited and the extent of the access for each person is determined by their particular duties relating to alternative investments. Each person with access must sign a confidentiality agreement kept on file in the EIM office. Because all correspondence with the fund managers comes into the EIM office, the Controller's Office relies on EIM to place all pertinent documents on the shared drive.

Database

An important first step in monitoring alternative investments was the creation of a database. The database was built using Microsoft Access and houses information that is examined and filed as discussed below, including annual financial statement information, audit confirmation information, email names and addresses for contacts at each of the funds, public securities held, and contribution and distribution information. (See Appendix A for database structure.)

Rollforward

One of the most helpful tools for Emory in monitoring alternative investments is a rollforward report. The rollforward begins with the 08/31 (of the previous year) value. Each month sales (returns on capital/distributions) and purchases (capital calls) are

entered in the database for each fund (See Appendix B). A report from the database adds them to the previous month's balance. These totals each month are compared against the fund balances at our custodian bank. At quarter end, when statements are available from the funds, unrealized appreciation/depreciation is added. In addition to entering the information for the rollforward, each cash flow (capital call, distribution) reported on the sales/purchases statements from the custodian bank is matched to the letter requesting the capital call or report of the distribution from the fund for accuracy. All the official (capital call/distribution) letters are scanned and kept on the shared drive. By following these procedures, the Controller's Office has confidence that all call/distribution letters have been accurately reflected on the Emory's books in the market value of the assets.

The process changes a little as soon as the Annual (December) Financial Statements are received from each of the funds. "Official" 12/31 valuations from the fund are entered directly into the database (see Appendix C). Emory Investment Management scans all the Financial Statements onto the shared drive. Again, as June statements are received, the 06/30 balance from each fund is entered and scanned to the shared drive.

The auditors are most interested in the rollforward beginning with the 06/30 "official" valuation from the fund as this is the last valuation before the end of Emory's fiscal year. As soon as the 06/30 values have been entered, a rollforward report is completed showing the 06/30 balance and all cash transactions (capital calls/distributions) that have taken place in July and August.

Checklists

Checklists are also used to monitor the information received from each of the funds including a master list of all the alternative investment funds. As annual financial statements and quarterly valuations are received, they are logged in the checklist. If, after a reasonable period of time, any of this information is not available, the Controller's Office contacts the Emory Investment Management Office to have them initiate contact with the fund manager to try to obtain the information.

Review of Individual Funds

Another important aspect of monitoring the alternative investments is the review of each individual fund. As the 12/31 financial statements are made available, data is recorded from the statement into the alternative investment database (See Appendix D). The information compiled includes management data (names of managing firm, current auditor, date of latest audit letter, legal advisors, changes in management team), financial data (breakdown of investments by types of securities and geographical locations, most recent returns, percent of Emory's ownership, total capitalization) and other miscellaneous data (analysis of notes to the financial statements, write-off activity). In addition to inputting the information into the database, the Controller's Office reads each statement for unusual activity and/or changes in the fund. Special attention is given to the footnotes to the financial statements looking for changes and/or adoptions of new accounting policies.

The Emory Investment Management Office keeps all the “official” records of the funds and their managers. In addition, the EIM staff meets annually with the fund managers and files all notes from those meetings. Once a year, a Controller’s Office employee goes through all the files in the EIM office to check for any notations that may raise concern about the viability of the fund.

Audit Confirmations

Each year, Emory provides a listing of all alternative investments and their corresponding 08/31 balance to the auditors. From that list, the auditors select a sample to which they send confirmations. Emory has made the decision that each alternative investment will be confirmed. Two different letters are sent out – one to the auditor’s selected sample, and a second to the other alternative investments that were not selected for the sample. The Emory confirmation has been modified to include more information than the AICPA practice aid recommends. This is integral to management’s comfort in verifying the valuation, which Emory considers more important than the auditor’s opinion (See Appendix F).

All confirmations (auditor sample and Emory sample) are sent on September 1st with a due date of September 15th. Emory’s confirmations are emailed to the fund and are returned to Emory by email and/or fax. The auditors sample is sent by mail and is returned to the auditor who passes a copy onto Emory. All returned confirmations are scanned and stored on the shared drive.

As the confirmations are returned, all reported information is entered into the database (See Appendix E). Information from the confirmation includes: name of fund, fund number, 06/30 (prior year) balance, contributions and distributions from 07/01 (prior year) to 06/30 (current year), 06/30 (current year) balance, total capital commitment from Emory, capital received (inception to date), remaining capital due from Emory, total fund capital (all investors), Emory's percentage (of total fund) of capital, percentage of total investment in private assets, any changes noted for July and August (current year). To the current year 06/30 balance are added any contributions and distributions for July and August to come to a 08/31 (current year) balance. This balance is then compared to the general ledger balance for that fund at the custodian bank. Any material differences are analyzed and explained.

In the past few years, the volatility of the market between June and August has raised issues of public security valuation. Many of the alternative investment firms hold positions in public securities. As part of the confirmation process, the number and name of any public security is requested. This information is entered in the database and the valuation change in these securities from June 30 to August 31 is noted. If the changes are material, an adjustment is made to the market value at the custodian bank.

A development in alternative investments recently has been the rise of Alternative Investment Vehicles (AIVs) in these funds. It is important to remember as one is reading the confirmation that all parts of the funds (including AIVs) should be included in the

fund balances. Any discrepancy or concern are addressed with EIM to determine the proper presentation of the fund.

A final value for each fund is determined to be:

- + June 30 market value as reported by fund
- Capital calls (July and August)
- + Distributions (July and August)
- +/- Adjustment for public security valuations (July and August)

BENEFITS

The most important benefit of the implementation of the alternative investment monitoring process is the accurate representation of these investments on the balance sheet of Emory University. A secondary benefit Emory expects to reap is the ability to respond quickly and efficiently to auditor's request for information contributing to the completion of the annual audit in a successful and timely basis.

RETROSPECT

We anxiously await this fiscal year's audit to confirm the validity of this project. By the April 2009 SACUBO meeting a more detailed analysis will be completed.