Alternative Investments

Accounting, Auditing, and Tax Concerns

Michelle Sanchez, Partner
Daren Daiga, Senior Manager
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CAPINCROUSE LLP

Agenda

- Introduction
- Overview of Alternatives
- Accounting Issues
- Audit Issues – and how you can help!
- Tax Reporting Considerations

Introduction

- Michelle Sanchez, CPA
  - Partner
  - 15 years of experience
- Daren Daiga, CPA
  - Tax Senior Manager
  - 11 years of experience
- CapinCrouse LLP
  - 45 years of serving ONLY nonprofit organizations
  - Majority are faith-based
  - National firm with clients in 45 states

Overview of Alternatives

- Definition
  - Who knows?
    - An investment that is not one of the three traditional asset types (stocks, bonds and cash). Most alternative investment assets are held by institutional investors or accredited, high-net-worth individuals because of their complex nature, limited regulations and relative lack of liquidity. Alternative investments include hedge funds, managed futures, real estate, commodities and derivatives contracts.
      www.Investopedia.com

Overview of Alternatives

- Definition
  - AICPA NFP Section
    - Alternative Investments represent investments for which a readily determinable fair value does not exist (that is, investments not listed on national exchanges or OTC markets or for which quoted market prices are not available from sources such as financial publications, the exchanges, or NASDAQ). These investments include private investment funds meeting the definition of an *investment company* under the provisions of the AICPA Audit and Accounting Guide, *Investment Companies*, such as hedge funds, private equity funds, real estate funds, venture capital funds, commodity funds, offshore fund vehicles, and fund of funds, as well as bank common or collective trust funds. Alternative investments may be structured as limited partnerships, limited liability corporations, trusts or corporations.

Overview of Alternatives

- Many alternative investments also have high minimum investments and fee structures compared to mutual funds and ETFs. While they are subject to less regulation, they also have less opportunity to publish verifiable performance data and advertise to potential investors.

Overview of Alternatives

- Alternative investments are favored mainly because their returns have a low correlation with those of standard asset classes. Because of this, many large institutional funds such as pensions and private endowments have begun to allocate a small portion (typically less than 10%) of their portfolios to alternative investments such as hedge funds.
- While the small investor may be shut out of some alternative investment opportunities, real estate and commodities such as precious metals are widely available.

Overview of Alternatives

- Types of Alternatives
  - Limited Partnerships
  - Feeder Funds
  - Offshore Funds
  - REIT

Accounting Issues

Example:

Board votes to allocate 10% of $25 million endowment into alternative investments. Investment advisor recommends ABC Hedge Fund. This fund is organized as a LLP. The stated purpose of the fund is to minimize volatility and to return approximately 7% per year. The fund will invest in equities, fixed income, and private equity and will hedge investments within the fund. Your organization is a June 30 year-end. On January 1, 2016 you invest $2.5 million into ABC Hedge Fund. On June 30, 2016 you receive a letter from the manager of the fund stating that the fund is underperforming slightly and the underlying securities have taken a loss. The manager estimates that your investment is $2.3 million at fair market value as of June 30.

- What are your initial responsibilities?
- What are your ongoing responsibilities?
- What do you need to provide to the auditors?
- What is the manager's responsibility?

Accounting Issues

- Management Responsibilities:
  - Due Diligence
    - What was done to assure the fund is a trustworthy and legitimate investment vehicle?
      - Inspection of legal documents
      - Inspection of full prospectus
      - Review of audited statements
        - Was it a national firm that audited the fund?
        - What types of valuation methods are used?

Accounting Issues

- Management Responsibilities:
  - Due Diligence (continued)
    - What type of communication does the fund provide?
    - What are the terms of the investment?
    - What is the benchmark they are committing to?
    - What is the background of the management team?

Accounting Issues

- Management Responsibilities:
  - Monitoring
    - Listen to investment update calls
    - Read each and every correspondence to come from investment company
    - Understand the underlying investments
    - Understand the benchmarks used
    - Stay informed of any news regarding the management company and the fund

Accounting Issues

- Management Responsibilities
  - Valuation and Existence
    - Management has the responsibility for both of these assertions over the investments in the financial statements
  - AICPA
    - "Management's responsibility for the preparation and fair presentation of the financial statements includes applying the requirements of the applicable financial reporting framework to the valuation of financial instruments… A thorough understanding of the financial instrument being valued allows an entity to identify and evaluate the relevant market information available about identical or similar instruments that should be incorporated into the valuation methodology."

Accounting Issues

- Existence
  - Sounds easy, but how does management support the assertion?
    - Correspondence
    - Detailed records of purchases and sales
    - Audit reports
    - Roll forward work paper from audit date to entity's audit date
    - Investment manager statements

Accounting Issues

- Valuation
  - This can be the tricky one
  - What is the valuation policy of management?
  - What assumptions are being made?
  - Which of these assumptions have the greatest risk of material misstatement?
  - Which assumptions have the great sensitivity risk?
  - Does management rely on a third party to assist in the valuation?

Accounting Issues

- Ultimately, it is management's responsibility to be able to support the assertions of existence and valuation

Audit Issues

- This is where the fun begins!
  - At least for the auditor!
  - Key issue for auditors – we state that:
    - **"We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion."**
    - **"In our opinion, the financial statements referred to above present fairly, in all material respects…"**

Audit Issues

- How do we get to that opinion with alternative investments?
  - Confirmations
  - Analysis of management's efforts
  - Investment advisor input
  - Third-party valuation
  - Great spreadsheet analysis
  - Fingers crossed

Audit Issues

- Au-C Section 540
  - *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*
  - This is the guidance given to auditors when auditing an area of a financial statement that has an estimate involved

Audit Issues

- Various audit procedures
  - Confirm the alternative investment
    - With whom?
    - Does this provide enough audit evidence?
      - Typically no!
  - Review (and test) the entity's assumptions and underlying data
  - Review (and test) analysis (by management) of the assumptions and data obtained from the fund manger

Audit Issues

- Reconcile to audited financial statements as of the same date
  - This is typically not possible — most funds are calendar year-ends and many NFPs are not
  - HOWEVER — the auditor should reconcile the audited statement (from December) to what management has recorded on an interim basis —— or even to the prior year
    - If there are large swings after the fact, it could be indicative of management not having a proper valuation system in place

Audit Issues

- Review transactions at or near the date of the statement of financial position of the client
  - First – did the client have any new investments in or redemptions out of the fund?
  - Second – did any other partners/investors have investments in or redemptions out of the fund?

Audit Issues

- Written representation from management
  - Management should be able to state that they believe that significant assumptions used in making accounting estimates are reasonable
- Communication with those charged with governance
  - The auditor is responsible for communicating with those charged with governance relative to the auditor's views about the qualitative aspects of the entity's significant accounting practices, including accounting estimates

Tax Reporting Considerations

1. Initial responsibility – Before you invest, in order to determine potential tax filings and assess the cost of those tax filings
2. Ongoing responsibility – Each tax reporting year, in order to determine actual tax filing requirements and complete those filing requirements

Initial Responsibility – Before You Invest

1. Obtain information on investment (offering memorandum, prospectus, partnerships agreement)
2. Ask questions
   - Investment structure: Partnership, Trust, Corporation?
   - Foreign or domestic?
   - Will the fund generate unrelated business income?
     - Is there a blocker corp?
     - State reporting requirements?
     - State composite returns?
     - Withholding?
   - Are there potential foreign reporting requirements?
   - Will investment generate a K-1?
   - How will the fund communicate reporting requirements to you?

Ongoing Responsibility – Each Tax Reporting Year

1. Compile listing of all investments
2. Organize by entity structure (Partnership, Corporation, etc.)
3. Collect and analyze all K-1s received
4. Request information for investments for which you do not receive K-1s
5. Prepare and file tax filings

Most Common Potential Tax Filings

- Form 990-T – Exempt Organization Business Income Tax Return and related Forms
- State Equivalent UBI filings
- Form 926 – Return by a US Transferor of Property to a Foreign Corporation
- Form 5471 – Information Return of US Persons With Respect to Certain Foreign Corporations
- Form 8621 – Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund
- Form 8865 – Return of US Persons with Respect to Certain Foreign Partnerships
- Form 8886 – Reportable Transaction Disclosure Statement

Schedule K-1 Considerations

- Partnership, S Corp, or Trust
- Tax year
- Partner – Type of entity
- Ownership percentage
- Capital account analysis
- Final/Amended K-1
- Codes
- Notes
- State K-1s

Considerations for Investments Not Receiving Schedule K-1

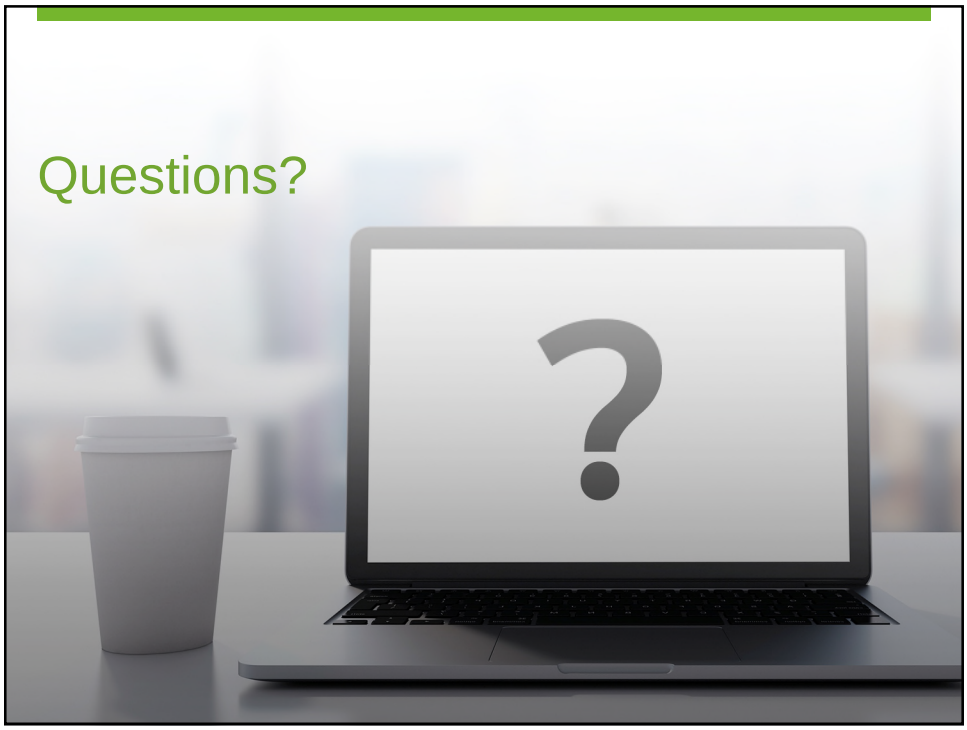
- Type of organization (i.e., foreign corporation, foreign partnership)
- Country of organization (Form 990, Schedule F)
- Amount transferred to investment during the tax year
- Amount distributed from investment during the tax year
- Investment balance at end of year (Form 990, Schedule F)
- Ownership % at BOY
- Ownership % at EOY
- If foreign investment, is it a controlled foreign corporation?
- Potential UBI

Conclusion

- Alternative investments are complicated.
- Valuation, especially, is a very difficult assertion to support.
- Management has the responsibility of determining the proper value (estimate of value).
- The auditor has the responsibility of testing management's assertions to the value of the investment.
- The auditor will rely on many sources to test management's assertions.

Conclusion

- Always communicate with your outside auditor when adding alternative investments to your investment portfolios. (P.S. It will cost more to audit — but better to have auditors informed ahead of time.)
- Do not rely on outside managers alone.



Thank you.

Michelle Sanchez, Partner
CapinCrouse LLP

msanchez@capincrouse.com
619.955.5333

Daren Daiga, Senior Manager
CapinCrouse LLP

ddaiga@capincrouse.com
317.885.2620

CAPINCROUSE LLP