Auditing Investment Operations
DO YOU KNOW WHERE YOUR MONEY IS GOING?

Bob Hoster
Director of Internal Audit, Bucknell University

Beth Walsh
Senior Audit Manager, Stanford University

John Kiss
Senior Manager, Baker Tilly

Kimberly Burkett
Manager, Baker Tilly

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Objectives

- Provide a general overview of key investment and endowment operations
- Examine audit considerations for investment and endowment activities
- Share leading industry practices and case studies, to support an effective audit of investments

Agenda

> Investment Office Background and General Overview
  - Responsibilities
  - Strategy
  - Policy
  - Due Diligence
  - Operations and Functions
> Auditing Investment Operations
  - Back Office
  - Middle Office
  - Front Office
> Other Considerations
Investment office background and general overview

Key questions

- What are the responsibilities of an investment office?
- How does a university develop its investment strategy?
- What are some investment policy and due diligence considerations?
- How are investment operations organized?

Investment office responsibilities

- Authorize investment transactions
  - Purchasing and selling securities, making commitments to alternative investments

- Receive or deliver securities
  - Receiving, safeguarding, and delivering securities
  - Receiving periodic income

- Record transactions
  - Recording purchases, sales, and income
  - Recording market adjustments and reclassifications
  - Reviewing purchases, sales, and income transactions

- Settle transactions
  - Receiving and disbursing cash
  - Assessing investment performance and reporting

Governance

Investment policy and investment strategy
Investment strategy

Factors to consider
>
- Overall size of endowment
- Current spending rate (percentage of endowment transferred to operating fund)
- Risk and rate of return
- Types of donors for endowments, grants, and contributions
- United States versus international assets
- Allocation between traditional stocks and bonds and alternative investments

Investment policy considerations

1. Does your institution have an investment policy statement?
2. Is the investment policy consistent with the Uniform Prudent Management of Institutional Funds Act (UPMIFA), if applicable, and state law?
3. Is there a board committee responsible for investments? How often does it meet?
4. How is investment performance currently monitored? What investment performance benchmarks are used?
5. Have the cost of investment managers been evaluated?
6. Are the investments subject to any unusual regulations or tax implications?
7. Was a policy adopted regarding investments in companies that may conflict with the organization’s mission?
8. Has the organization transferred cash and investments to any related organizations?
9. Who manages the portfolio and are any unique skills required of the portfolio manager?
Investment policy considerations

A good investment policy:
> Spells out the investment decision making process, including the use of prudent experts
> Identifies the intended diversification of assets with regard to specific risk/return objectives
> Sets forth the methods intended to control investment expenses and ensure the "best execution" of investment transactions
> Sets forth the procedures used to monitor the activities of all investment managers, endowment funds, and service providers
> Provides an auditable framework from which to assess adherence

Key due diligence considerations

Risk management disciplines
Team biographies
Film evaluations
Manager reporting
Observation (Conflicts of interest)

Monitor rankings
Aftermarket analysis
Calls with fund managers
Quarterly written updates
Regular manager meetings
Realization of capital

Quantitative Analysis
Due Diligence Areas
Volatility and drawdown
Regions
Performance analysis
Datastream
Financial statements
Spectrum IQ
Operational capabilities
Credit risk

Due Diligence Areas
Organized Due Diligence and Monitoring
Risk management disciplines
Fund evaluation
Manager reporting

Due Diligence Areas
"Indirect" Research
Background and reference checks
Regulatory filing
Public filings
Other investors
Industry network

Three functions within the investment office

Back Office
Trade settlement
Dealing with the custodian
Trade and investment reporting
Investment accounting

Middle Office
Valuation and performance management
Operational due diligence
Counter-party management

Front Office
Investments and research
Short-term trading and research
Portfolio monitoring
Financial reporting

Accounting and finance
Quantitative analysts
Portfolio managers, traders, research analysts
Operations management

**KEY CONSIDERATIONS**
- Training
- Segregation of duties
- Management oversight
- Appropriate leverage level
- Internal controls
- Risk management system
- Understanding inherent risks
- Compliance

Auditing Investment Operations

**Presenter profiles**

- **Bucknell University**
  - Location: Lewisburg, PA
  - Setting: Rural
  - School Type: Private
  - Undergraduate Enrollment: 3,295
  - Graduate Enrollment: 58
  - Number of Employees: 1,250
  - Size of Audit Department: 1

- **Stanford University**
  - Location: Silicon Valley, CA
  - Setting: Suburban
  - School Type: Private
  - Undergraduate Enrollment: 7,199
  - Graduate Enrollment: 9,776
  - Number of Employees: over 12,000
  - Size of Audit Department: 23

- **Baker Tilly**
  - Location: National
  - Setting: Rural, Urban, Suburban
  - School Types: Private, Public, For Profit and Not For Profit
  - Total Employees: over 2,500
  - Number Higher Education Audit Employees: over 170
Back office leading practices
Trade settlement

> Segregation of duties between trade settlement and trading
> Regular reconciliation of trade confirmations with trade settlements and order tickets with confirmation advice
> All trades are authorized, within risk limits, and approved
> Trade settlement infrastructure is automated when possible
> Backup and recovery procedures are in place

Back office leading practices
Dealing with the custodian

> Authorization from the organization before custodian executes trades or releases capital calls for alternative investments
> Timely communication and resolving of discrepancies and exceptions
> Automatic submission of custodian information (e.g., income from dividends and interest) for electronic posting to accounting system
> Communicating custodian (or internal) forecasting of cash availability to portfolio managers and traders
> Review of custodian or outsourced transaction vendor

Back office leading practices
Trade and investment reporting

> Review reports before sending them to management, including tracing information to source data
> Record retention in accordance with relevant regulations
> Automate reporting when possible
> Establish appropriate segregation of duties across the reporting function
Back office leading practices

Investment accounting

> **Automated trade entry** into the accounting system
> If traders enter trades into the accounting system, they should be released by accounting staff to ensure **segregation of duties**
> **Reconciliation** of accounting system data with other systems and financial statements
> **Prompt resolution of income and dividend variances**
> **Proper user access controls** within the system

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Auditing the Middle Office

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Accounting and finance

Quantitative analysts

Portfolio managers, traders, research analysts

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Middle office leading practices

Valuation and performance management

> Quarterly or monthly valuation of overall investment portfolio including ensuring **updated and timely valuation** of each investment.
> Comparison of investment or fund performance to **benchmark returns, peer groups or historical returns**
> Monitoring lists of authorized traders, and approved trading instruments and companies/brokers
> **Exception reporting** for XX% change in valuation, follow up with front office for explanation
> **Periodic Valuation Committee meetings** to review valuation policy, exceptions, and adjustments and to address significant financial reporting issues
Middle office leading practices
Operational due diligence

- Operational due diligence (ODD) supports investing and valuation. ODD reviews include:
  - Cash-wire controls
  - IT Application systems & instruments
  - Policies regarding valuation and personal trading
  - Service providers – custody – counterparties – auditors
  - IT & disaster recovery
  - Background checks of individual managers
- Audit can review documentation of these reviews and follow up actions taken on identified issues

Middle office leading practices
Counter-party management

- Maintain an assessment and approval process for counter-parties
- Establish counter-party limits including credit limits and tenor limits
- Standardize International Swaps and Derivatives Association (ISDA) agreements and identify critical terms
- Validate counter-party collateral calculation for over-the-counter (OTC) derivatives

Auditing the Front Office
Front Office Leading Practices
Investments and research

- Face to face meetings with investment firm management – calendars, agendas, and meeting notes
- On-site visits to investment firm and portfolio investment operations
- Reference checks from other investors, service providers, investee companies and background checks of senior management
- Review of detailed policies and procedures specific to trading

Front Office Leading Practices
Investments and research (cont’d)

- Clearly communicated and enforced approvals and authorizations
- Segregation of duties (for example, traders unable to update accounting and pricing systems)
- Document review by investment staff-offering memorandum, legal agreements, pitch books, and financial statements
- Investment memorandum presentation and response to investment team input
- Resolution of legal and business issues in underwriting documentation

Front office leading practices
Short-term trading and research

- Detailed policies and procedures specific to short-term trading
- Lists of authorized traders, and approved trading instruments and companies/brokers
- Mentoring and training for less experienced traders by more experienced managers
- Segregation of duties between short-term trading, settlement, and reporting
- Predefined risk parameters
Front Office Leading Practices
Portfolio monitoring
- Attending quarterly and annual meetings, periodic manager meetings – by telephone or in person
- Participating on an advisory board or holding a board observer seat
- Following weekly valuation and performance metrics
- Reviewing shareholder letters/financial statements – fund manager discussion of positions and market
- Reviewing exception reports to address changes in valuation
- For drawdown funds, comparing partners’ capital statement with internal transaction record of unfunded commitment

Front Office Leading Practices
Financial reporting
- Valuation roll-forward to support fiscal year end valuations
  - General Partner’s (GP) June recorded net asset value (NAV) is tested with a roll-forward analysis of cash flows
  - Audited December Stanford NAV plus cash flows to June are compared to the GP June NAV
  - Difference is realized and unrealized gains
  - Front office investment managers review and attest to reasonableness of changes in valuation
- Maintaining data repository for signed legal agreements to support existence and ownership of investments

Other Considerations
Additional investment strategies

An alternative investment is one not readily listed on an exchange and does not have a readily determinable fair value.

- Private investment funds
- Real estate funds
- Equity funds
- Hedge funds
- Venture capital funds
- Real assets

Alternative investments leading practices

Accounting guidance

- Financial Accounting Standard (FAS) 157 provides measurements for applying fair value to interests in alternative investments. This Financial Accounting Standards Board (FASB) Codification has been updated to Accounting Standards Codification (ASC) 820.

- Accounting Standards Codification (ASC) 820 provides that “a reporting entity is permitted, as a ‘practical expedient,’ to estimate the fair value of an investment using the NAV per share of the investment, if the NAV per share of the investment is calculated in a manner consistent with the measurement principles of Accounting Standards Codification Topic 946, Financial Services-Investment Companies as of the reporting entity’s measurement date.”

Alternative investments

Valuation responsibility

- It is management’s responsibility to support their assertion of investment valuation and develop appropriate controls to ensure the accuracy of the reported value of its alternative investments.

- The fund manager can provide guidance, but management must have sufficient information to be able to independently evaluate and challenge the valuation.

- Key challenges include:
  - Management access to and understanding of underlying investments
  - Liquidity of underlying investments
  - Availability of market values for underlying investments
  - Ability to obtain a full listing of underlying investments
  - Input is required from the Middle & Front Offices for alternatives
Alternative investments leading practices
Audit considerations

> Management’s controls related to alternative investments should include procedures for:
  > Initial Due Diligence – procedures performed before the initial investment - primarily the responsibility of the Front Office
  > Ongoing Monitoring – procedures performed post-investment - many Front Office responsibilities, others as discussed for Back & Middle Office
  > Financial Reporting – Management responsibility for overall strategy and compliance with formal investment policy, review of funds’ audited financial statements, basis of accounting, significant policies/procedures, audit opinion, subsequent events

Alternative investments leading practices
Audit considerations (cont’d)

> Audited financial statements of the alternative investment entity
  > Provides accurate financial information for valuation purposes including method of valuation and related party transactions
> Audit opinion should be from a recognized audit firm (‘Big Four’ firm or recognized large regional firm)
> Analysis of unrelated business taxable income (UBTI) arising from the alternative investment activities unrelated to the tax-exempt organizations (i.e. college or university’s) business purpose
  > Possible state tax exposure risk – consider hiring a tax expert specializing in UBIT to assist you
> Compliance with and monitoring of U.S. foreign filing requirements for foreign alternative investments

Resources

> The American Institute of Certified Public Accountants (AICPA) Practice Aid - Contains audit considerations for alternative investments
> Uniform Prudent Management of Institutional Funds Act (UPMIFA)
> Statement of Financial Accounting Standards No. 157 (ASC 820)
> Internal Revenue Service (IRS) Unrelated Business Taxable Income (UBIT) reporting requirements
Contact information

Thank you for participating today! Remember CPE certificates will be emailed to you by ACUA Headquarters in about three weeks.

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</tr>
<tr>
<td><a href="mailto:bob.heater@bucknell.edu">bob.heater@bucknell.edu</a></td>
<td><a href="mailto:elizabeth.walsh@stanford.edu">elizabeth.walsh@stanford.edu</a></td>
</tr>
<tr>
<td>570-377-3342</td>
<td>650-721-2120</td>
</tr>
</tbody>
</table>

| John Kiss           | Kimberly Burkett     |
| Senior Manager      | Manager              |
| john.kiss@bakertilly.com | kimberly.burkett@bakertilly.com |
| 703-923-8248        | 703-923-8693         |