



Hedge Fund Due Diligence Bulletin

A take on internal controls - Part I

Due to last year's financial crisis, analysis of a Hedge Fund's operation has become an important factor in investors' fund selection processes. In order to restore investors' confidence and attract more institutional investors, hedge fund managers, as well as other service providers (i.e. administrator, prime brokers, banks, etc.), have to take the undertaking to commit themselves to higher operational standards. The challenge lies in:

- identifying operational standards that will meet investors' expectations;
- making the necessary improvements in their processes to comply to these higher standards; and
- finding a convincing way to convey to the investors compliance to these standards.

In this article, we will address the pros and cons of the different solutions, currently available to investment managers, and the benefits investors may gain from the implementation of these solutions.

The solutions available can be classified into three main categories: (1) audit/accounting guidance, (2) industry driven standards and (3) private rating/certification.

1. Audit/Accounting guidance

Statement on Auditing Standards (SAS) No. 70, Service Organizations, is an auditing standard developed by the American Institute of Certified Public Accountants (AICPA). The original Statement on Auditing Standards (SAS) No. 70 was published in April 1992. The latest version of the Service Organizations: Applying SAS No. 70, as Amended – AICPA Audit Guide is dated September 2009. SAS No. 70 is a guidance that allows service organizations (i.e. investment managers) to disclose their control activities and processes to their customers and their customers' auditors. The issuance of a service auditor's report prepared in accordance with SAS No. 70 signifies that a service organization has had its control objectives and control activities examined by an independent accounting and auditing firm. The service auditor's report, which includes the service auditor's opinion, is issued to the service organization at the conclusion of a SAS 70 examination. There are two types of Service Auditor's Reports: Type I and Type II. Type I report describes the service organization's description of controls at a specific point in time. Type II report does not only include a service organization's description of controls, but also a detailed testing of the service organization's controls over a minimum six month period.

The control objectives and control activities described in the report are the responsibilities of the service organization(s). If the control objectives are deemed incomplete by the service auditor, he may qualify the SAS 70 report. The AICPA provides the following suggested list of control areas to be covered in the report: new account setup & maintenance, trading/settlement, contributions/distributions, new security setup and maintenance, valuations, investment income, corporate actions, reconciliation and client reporting. The scope and content of the report will usually be decided between the organization and the auditor. In reality, the content of a SAS 70 report varies from one organization to another and therefore does not provide a uniform way in which the information is to be presented.

Another accounting guidance was issued by the Audit and Assurance Faculty of the Institute of Chartered Accountants in England and Wales in June 2006 to provide guidance to reporting accountants on undertaking an assurance engagement and providing a report in relation to internal controls of a service organization. This guidance came as a replacement of the FRAG 21/94 guidance that was last reviewed in 1997. Assurance engagements require a reporting accountant to express an overall conclusion on the information assessed relative to certain criterion. In an assurance report on internal controls, control criterion include, like for the SAS 70 report: the control objectives around which the service organization has designed its control procedures.

**All the
Hedge Fund
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Team
wishes you a
happy and
prosperous
year 2010**



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Reporting accountants consider the control objectives and observe supporting control procedures specified by the service organization so as to form an overall opinion in the specific engagement circumstances at the time the work was undertaken. Reporting accountants also consider the linkage of the control procedures to the stated objectives and try to obtain sufficient evidence to support their opinion. Through tests of the control procedures, reporting accountants obtain sufficient evidence to conclude whether or not the relevant specified control objectives are met.

In comparison to the SAS 70 guidance, Appendix 1 of AAF 01/06 sets out detailed control objectives for the following financial services activities: custody, investment management, pension administration, property management, fund accounting, transfer agency, information technology, private equity, investment administration and hedge fund management. For hedge fund management, the guidance document lists 32 control objectives under the following categories: accepting clients, authorizing and processing transactions, maintaining financial and other records, safeguarding assets, monitoring compliance, reporting to investors and information technology. The service organization must address all of the control objectives specified in the guidance document and explain any additions or omissions.

Investment management organizations, which prepare internal controls report following the SAS 70 or the AAF 01/06 guidance, provide a thorough disclosure of their operational infrastructure to their investors, and also allow themselves to be scrutinized by an external audit. Completion of such a report is not a guaranty of sound operation practices. Indeed, investors need to read through the reports to ensure that they are covering all the areas of interest to them and that the auditors have given an unqualified opinion. Among the two guidance documents, SAS 70 is currently the most widely used guidance in the financial industry. A lot of hedge fund administrators went through either a Type I or Type II report. The SAS 70 report is also widely used by investment managers running significant long only activity along their hedge fund products. Reports prepared following the SAS 70 or AAF 01/06 guidance offer an independent view of an investment manager's operations and should be used as a support tool by investors in their due diligence process.

The other solutions will be covered in the upcoming newsletters.

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