Audited Financial Statements:
Operational Due Diligence Primer

DUE DILIGENCE UNIVERSITY®

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Introduction

A fund's financial statements represent foundational due diligence evidence, particularly for ongoing monitoring of existing investments. However, the review of audited financial statements ("AFS") is a challenging due diligence obligation. The AFS review process is time compressed, the workload can be voluminous, and spreadsheets are inflexible and cumbersome as reporting tools. Above all, how does the diligence team validate and evidence that 80% of funds have no financial reporting issues - and then target in on the 20% where the financial statements could raise diligence issues?

This Due Diligence University Primer provides an overview of the different areas of AFS review. We hope that these comments help institutional investors enhance their due diligence programs when investing in hedge funds, private equity partnerships and long only funds.

This due diligence primer covers the following areas:

- Auditor
- Audit Opinion
- Accounting Framework
- Balance Sheet Analysis
- Portfolio Valuation
- Asset Flows & Shareholder / Partner Equity
- Income Analysis
- Fees & Expenses
- Other Expenses
- Notes to Financial Statements

Auditor

- **Who is the auditor?** The audit firm selected should have a demonstrated track record of providing audit services to investment funds and other financial services companies. The auditor should have adequate resources, commensurate with the complexity of the fund's strategy and asset base.

- **Has the fund appointed a Big 4 auditor?** The "Big 4" (Deloitte, KPMG, EY and PwC) offer global service reach. However, smaller audit firms may also be able to offer cost effective, specialist servicing. The investment manager should always have a clear rationale as to their selection criteria for the fund auditor.

- **Has the fund's auditor changed within the past three years?** Investors should discuss the reasons for the change in auditor with the manager and ensure that there is sufficient comfort with the capability and reputation of the new audit firm.

- **Is the auditor conflicted?** Audit rules generally prevent the auditor from auditing, for example, a public portfolio company owned by a private equity firm. However, the auditor is still able to provide consulting services to that PE firm as they buy other potential investments (e.g. tax, due diligence, structuring): such consulting fees may be significantly more than the audit fee. High levels of "other" fee income may, evidently, impact audit independence.

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Audit Opinion

- **Letterhead and signed?** While basic, is the audit on appropriate auditor letterhead and is the opinion in the financial statements received by the investor actually signed?

- **Qualified opinion?** While extremely rare, a qualified audit opinion is an obvious red flag for investors.

- **Emphasis of matter?** An emphasis of matter paragraph does not indicate a qualification; however, it is a material subject which the auditor has elected to "emphasize". Investors should evaluate the nature of the matter discussed and seek further information from the manager as necessary.

- **Timeliness of opinion:** Audits should typically be issued within 4 months for hedge funds, while PE and funds of funds would typically be within 6 months. A late audit report could suggest potential problems gathering audit evidence or disagreement between management and the auditor as to financial statement numbers and note presentation. Investors should identify which opinions are "late" and escalate for additional due diligence.

- **Audit opinion addressee:** Is the opinion addressed to the investors? Audit firms may address the audit opinion only to the General Partner (the investment manager) or the board of directors, deliberately excluding the shareholders / limited partners from the scope of their audit opinion. This practice materially reduces the value of the audit process for investors.

- **"Bannerman" and other liability waivers:** A recent trend is for some auditors to adopt variants of the "Bannerman" paragraph to further limit liability. Liability exclusions may further diminish the reliance investors may place on the audited accounts.

Accounting Framework

- Most investment funds' AFS follow US GAAP or IFRS (International Financial Reporting Standards).
- PE funds may, however, follow "other bases of accounting": it is not unusual to see the Limited Partners Agreement ("LPA") be used as the stated accounting framework, typically modifying the requirements of US GAAP or IFRS. Use of these "non-standard" AFS / GAAP reporting frameworks can create material risks for investors.
- A large portfolio of funds (HF, PE, Long Only) would typically follow a wide range of different accounting standards and related accounting frameworks:

- AASB (Australia)
- Canadian GAAP
- Danish Act
- Dutch GAAP
- FRS 102 (UK and Ireland)
- German GAAP
- IFRS
- Income Tax Basis
- LPA
- Luxembourg GAAP
- Other
- SFRS
- UK GAAP
- US GAAP

Accounting Framework

- There are considerable differences in the presentation of financial statements following US GAAP versus IFRS.

- US GAAP financials do not provide comparative information (IFRS does present a comparative).

- IFRS financials tend to provide more information than US GAAP and typically present more detailed and complex (but not necessarily more useful) footnote disclosures. It's not unusual to see a 50 page IFRS financial statement, even for a "straightforward" fund.

- Financial statements prepared following LPA or Income Tax basis may be very different in content and presentation compared to "GAAP" accounts.

- Non-GAAP financial statements may mislead investors. Key shortcomings can include:

    - Exclusion of important statements such as statement of net assets, statement of cashflows and financial highlights
    - Lack of standard disclosures in the statement of operations and statement of net assets
    - Exclusion of company / organization disclosures
    - Missing disclosures on significant accounting policies
    - Lack of explanations as to how illiquid investments are valued
    - Exclusion of fair value hierarchy disclosures
    - Lack of disclosures on related party transactions, commitment and contingencies and subsequent events

Balance Sheet Analysis

- **Balance sheet leverage:** Is balance sheet leverage greater than 150%? Strategies with higher leverage may be exposed to greater counterparty risk and may reflect strategies (e.g. fixed income relative value) which can be more operationally complex. Valuation risk also increases with high leverage (a 2% valuation error on a 5:1 levered portfolio will have a 10% impact on the net asset value of the fund).

- **Portfolio turnover:** Portfolio turnover can be calculated using audited financial statement data (purchases of securities per cash flow statement, divided by average net assets). Investors should check if the calculated turnover matches the fund's strategy: a "buy and hold" strategy should not have a turnover metric of 12, suggesting monthly turnover.

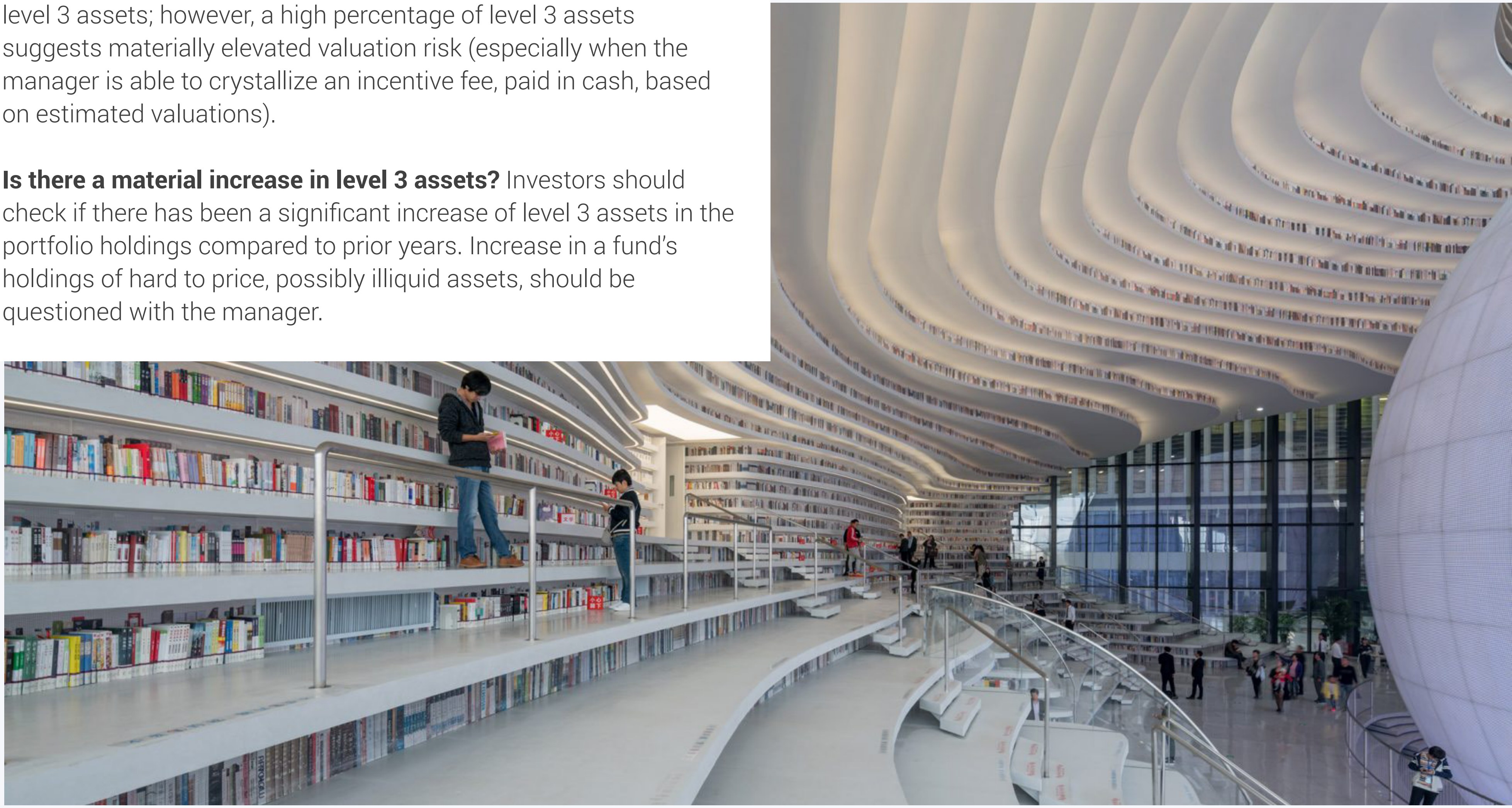
- **Inter company receivables and payables:** The balance sheet may show amounts due to or from other funds and companies controlled by the investment manager. The "related party" footnote should provide an explanation of inter company balances.

- **PE fund credit lines:** PE funds have traditionally used revolving credit facilities secured on investor capital commitments for short-term financing to bridge capital calls and provide greater flexibility to close a deal on short notice. However, the use of subscription credit facilities has expanded with longer term facilities now in place within many funds. The AFS footnotes typically provide details as to the terms of credit line(s) in place, making AFS analysis a key tool to identify and monitor lines of credit.

Portfolio Valuation

- **Is the percentage allocated to level 3 assets in excess of 25%**? It is not unusual for hedge funds and other open-ended vehicles to hold level 3 assets; however, a high percentage of level 3 assets suggests materially elevated valuation risk (especially when the manager is able to crystallize an incentive fee, paid in cash, based on estimated valuations).

- **Is there a material increase in level 3 assets?** Investors should check if there has been a significant increase of level 3 assets in the portfolio holdings compared to prior years. Increase in a fund's holdings of hard to price, possibly illiquid assets, should be questioned with the manager.



Asset Flows & Shareholder/Partner Equity

From the statement of changes in partners' capital, investors can consider:

Changes in Net Assets

- A significant **increase** in net assets year on year can create operational and organizational stress within the investment manager. The AFS review may suggest the need to escalate due diligence to ask the manager how the firm is responding to increased capital in terms of personnel, systems and procedures.

- A material **decline** in fund assets may indicate elevated operational risk. Redemptions due to weak performance may also mean, for a hedge fund, that the fund is below its high water mark for payment of incentive fees. This may impact the manager as a whole if the fund is a firm's flagship product; for smaller products, a decline in AUM and inability to generate near term incentive revenues may result in a decision to close the fund and return capital to investors.

Changes in GP and LP Balances

- The statement of net assets typically presents, within a partnership, the capital held by the General Partner (GP, the manager), and the Limited Partners (the LPs, the investors.) If the AFS review identifies material withdrawals of GP capital - or a failure to reinvest fee income back into the fund – investors may wish to follow up with targeted due diligence questions to the manager.

Adjustments

- While rare, the statement of changes in net assets sometimes includes "adjusting" items. Investors should consider the nature of these entries, and determine if they require a follow up with the manager.

Income Analysis

The income statement will generally provide a summary of any gains/losses as well as a summary of income and expenses.

Income Analysis

- Breakout of investment income: how much income was generated from portfolio interest and dividends?
- Breakout of realized vs unrealized gain/loss: A fund with high realized gains as a proportion of overall increase in net assets for the year (profit, i.e. fund performance) likely has reduced valuation risk. Alternatively, a fund with a high percentage of reported gains derived from unrealized appreciation may have elevated valuation risk, as performance is reported based on changes in value generated though the "paper profit" fair valuation process. A fund holding illiquid assets with a multi-year history of minimal realized gains has a particularly elevated valuation risk profile. AFS analysis is key to identify any such "outlier" funds.

Fees & Expenses

- **Management & performance fees:** Investors may wish to highlight funds with fees in excess of the industry 2% and 20% “standard”. Investors may also wish to calculate the “implied” management and incentive fee (fees reported in the financial statements divided by increase in net assets from performance gains). Implied ratios which diverge materially from the expected fee levels can be investigated following the AFS review.

- **Expense ratio:** Fees charged to a fund in addition to management and incentive fees are a critical issue for investors. As a baseline test, investors can use the AFS review process to identify all funds where the ratio exceeds 50 basis points.

- **Has the expense ratio increased?** Investors should highlight all funds where the expense ratio has increased year on year. Such increases may be the result of a change in fund net assets (the expense ratio would be expected to increase if AUM falls, given that certain fixed operational expenses will be spread over a reduced asset base). However, an increase in the expense ratio may indicate higher costs or new types of expenses being charged to the fund. Such situations should be subject to escalated diligence inquiry following the AFS review.

- **Organizational costs:** Investors should be conscious of; (i) funds looking to raise relatively small amounts of committed capital which nonetheless have high organizational costs; (ii) follow on funds with high expenses (offering documentation and legal work will be largely copied from prior funds) and (iii) potential for expenses such as travel and entertainment costs during the fund raising period. PE funds, in particular, frequently include marketing expenses within organizational costs, which would not be permitted in a hedge fund or long only vehicle.

- **Absolute $ value of expenses:** Particularly for larger funds, the overall expense ratio may be relatively low (significantly less than the 50 basis point threshold discussed above), but the absolute dollar value of expenses charged to the fund may remain significant. Highlighting these costs can identify multi-billion dollar funds which elect to pass high dollar value expenses (e.g. research costs, technology expenses, back office costs, legal fees etc.) even if the fund continues to have an “acceptable” expense ratio. Investors should consider the nature of “other” expenses and consider the manager’s rationale for charging costs to the fund. Expenses should also be in line with fund offering documents.

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Other Expenses

- In addition to expenses such as fund administration, audit costs and legal fees, funds may also incur further expenses. To enable effective investor due diligence and ongoing oversight over allocations to third party funds, investors must understand what expense items are charged to each fund entity. Thereafter, investors need a standardized categorization of expense items to allow comparison between funds.

- Unfortunately, auditors frequently sign off on accounts where "other expenses" is the largest expense item after audit and administration costs. Amalgamated "legal and professional" fees also lead to deficient financial statement disclosure – exactly what are the "professional" fees which have been charged to the fund? AFS review enables investors to triage their portfolios and identify funds where transparency, as to expense items, falls below average.

- Standardized expense categories which can be included in the income statement comprise:

  - Bank Fees
  - Broken Deal Expenses
  - Custody Fees
  - Data Fees
  - Debt Issuance Costs / Loan Facility Fees
  - Depositary Fees
  - Insurance
  - IT / System Expenses
  - Marketing Costs
  - Organization Costs
  - Research, Due Diligence & Deal Expenses
  - Syndication Expenses
  - Travel Costs

Notes to Financial Statements

Footnote disclosures can be lengthy, particularly when dealing with complex funds and strategies. AFS review should consider those notes that are most likely to include unusual or material items which could trigger further due diligence.

- Company / Organization
- Related Parties
- Commitment & Contingencies
- Subsequent Events

Company / Organization

Typically presented as Note 1, this section generally discusses the history and details of the fund. This section may include an overview of when the fund was incorporated and commenced operations. Other key information for private equity funds include committed capital, commitment period, investment period, expected termination date and arrangements for extensions, if any.

Notes to Financial Statements

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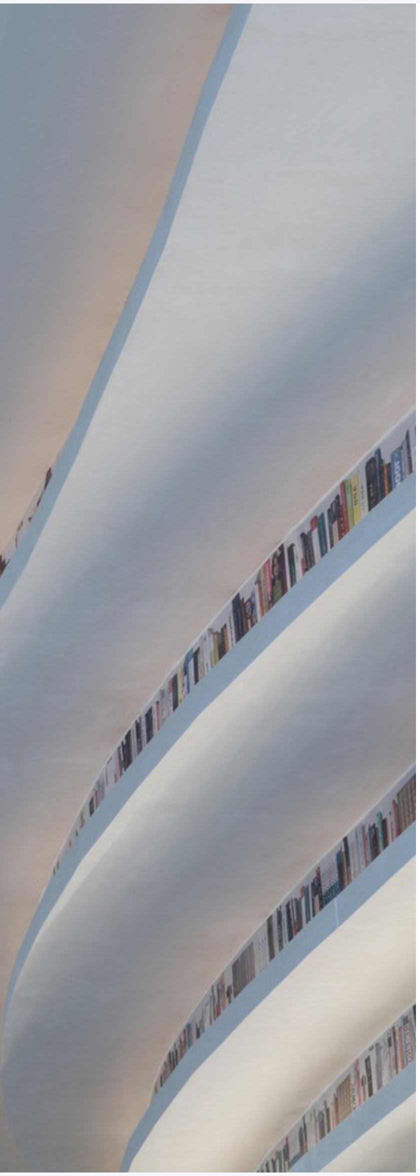

Related Parties

Related party disclosures may be material to an investor's understanding of a fund and its operations.

- Management fees, incentive fees payable to the General Partner/ Investment Manager.
- Aggregate value of capital owned by related parties, if any.
- Transactions between affiliates. Situations in private equity funds where an asset is sold from one vintage fund to another may be highly material to investors. Follow on investments alongside earlier vintage funds may also be highlighted, together with arrangements related to co-investment vehicles potentially controlled by an affiliated entity.
- Services provided to the fund by the investment manager or affiliates thereof (e.g fund administration or accounting services).
- Recharges of the salary costs of internal employees providing services to the fund such as accounting or legal.

Commitments and Contingencies

Investors should consider any contingent liabilities outstanding at year end. Legal cases noted (whether impacting the management company or the fund vehicle) may be impactful, and can be escalated to the manager following the AFS review process.

Subsequent Events

It is crucial that investors have an understanding of post balance sheet events. Subsequent events may include significant capital inflows / outflows, change in service providers, or change in ownership of the management company (e.g. the management company is taken over by another organization). All may merit subsequent due diligence escalation to the investment manager.

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