



# Alternative Investments

May 6, 2009

# Seminar Invitation

ARGY, WILTSE & ROBINSON, P.C.

## Upcoming Nonprofit Event

### Alternative Investments: Accounting & Tax Strategies for Nonprofits

**Diversification. Risk. Fair Value.**

Alternative investments can be part of an effective investment strategy, but they can come with significant risks and limitations. What are the challenges in accounting for alternative investments? How can nonprofit organizations navigate the complex accounting and tax issues involved?

Our panel of accounting, auditing, and taxation experts are pleased to present Kellye Jennings, Audit Partner at Argy, Wiltse & Robinson, P.C. Kellye has 25 years of auditing and consulting experience, specializing in the nonprofit and government contracting industries.

Come hear Kellye and our experienced panelists discuss the role of alternative investments in our challenging economic climate. Participate in our discussion as we examine the requirements and responsibilities that come with such investments. Learn about tax issues, including unrelated business income, tax shelter disclosures, and foreign reporting obligations.

2 hours of CPE credit will be offered at both seminar locations.

Please register below. Registration required for accurate headcount.

**Choose from two dates and two locations:**

**Date:** Wednesday, May 6th

**Time:** 7:30 a.m. Registration & Breakfast  
8:00 - 9:30 a.m. Program

**Location:** [City Club at Columbia Square, Washington, D.C.](#)  
[Click here](#) to register for May 6th in D.C.

**Date:** Wednesday, May 13th

**Time:** 7:30 a.m. Registration & Breakfast  
8:00 - 9:30 a.m. Program

**Location:** [Argy's McLean, VA Office at 8405 Greensboro Drive, 7th Floor](#)  
[Click here](#) to register for May 13th in Northern Virginia

# Agenda

- What is an alternative investment?
- How do alternate investments fit into a nonprofit investment strategy?
- How should alternative investments be accounted for?
- What are the nonprofit's responsibilities for the support of the fair value of alternative investments?
- Can a nonprofit outsource its responsibilities relative to alternative investments?
- What are some best practices for alternative investments?
- What are the tax implications and potential pitfalls of alternative investments?

# What is an alternative investment?

Alternative investments are defined as investments in private investment funds that meet the definition of an “investment company” under the provisions of the AICPA Audit and Accounting Guide, *Investment Companies*.

## Examples are:

- Hedge funds
- Private equity funds
- Real estate funds
- Venture capital funds
- Commodity Funds
- Offshore fund vehicles
- Funds of funds
- Bank common/collective trust funds

# How do alternate investments fit into a nonprofit investment strategy?

Factors to consider in assessing the risk of an alternative investment:

Management, governance and service providers -

- Quality and experience of fund management
  - Is this a new or established investment manager?
  - What is the quality and experience of management?
  - Does the investment manager demonstrate that he/she is specifically qualified to execute the strategy in the market in which the investee fund invests?
  - Is there evidence from similar endeavors of the ability of the principals to work together?
- Role and effectiveness of fund governance
  - Is there a Board of Directors? If so, are there independent members? Is the board effective?
- Quality of service providers
  - Are the auditors a reputable firm with the requisite knowledge and experience given the nature and complexity of the fund?
  - Who is the prime broker? Will they use multiple prime brokers?
  - Are the attorneys a well-established firm with appropriate industry experience?

# How do alternate investments fit into a nonprofit investment strategy?

Factors to consider in assessing the risk of an alternative investment:

Strategy, structure and key terms -

- Nature, complexity and liquidity of strategy:
  - What is the nature, complexity and liquidity of the investment portfolio?
  - Consider investment strategy, performance history, concentrations and exposures, asset classes, volatility, volume of transactions, leverage and use of derivatives.
  - What is the risk and complexity of the financial instruments in the portfolio
- Nature of fund's liquidity terms:
  - What is the liquidity of the investment fund? Consider subscription/redemption frequency, gates, early redemption charges, gates, side pockets, holdbacks, lock ups.
- Complexity of structure and key terms
  - What is the complexity of the investee fund structure and key terms? Consider management fees, incentive fees/allocations, carried interest, hurdle rate/preferred return, high-water mark, clawback provisions, loss carryforward, master-feeder, multi-tiered, side-by-side, fund-of-funds, side letters, special purpose vehicles, opt-out provisions.

# How do alternate investments fit into a nonprofit investment strategy?

Factors to consider in assessing the risk of an alternative investment:

Transparency and reporting –

- Nature and quality of transparency
  - What is the nature, extent and timeliness of the investee fund manager's reporting.
  - What level and quality of transparency is provided by the investee fund manager?
- Quality of financial reporting
  - Are the accounting policies and procedures consistent with industry practice? US GAAP, IFRS, tax basis?
  - Is the investee fund's year end coterminous with the investor entity's reporting year end?
  - Has the investee fund received anything other than an unqualified audit opinion in the last three years?
  - Do the financial statements contain a portfolio of investments? Is it condensed or detailed? Does it contain enough information to assess geographical or industry concentrations?
  - Are there unusual accounting policies or disclosures, including related party disclosures?

# How do alternate investments fit into a nonprofit investment strategy?

Factors to consider in assessing the risk of an alternative investment:

## Internal controls

- Adequacy of infrastructure, personnel and general internal controls.
- Design and effectiveness of valuation policies and procedures.
- Quality of risk monitoring.
- Impact of regulatory compliance matters.
- Impact of legal and tax matters.

# How should alternative investments be accounted for?



Alternative investments are carried at fair market value. SFAS 157, effective in 2008 for calendar year ends and in 2009 for fiscal year ends, provides a hierarchy of three levels of an assets or liability:

- Level 1 is quoted prices for identical items in active, liquid, and visible markets such as stock exchanges.
- Level 2 is observable information for similar items in active or inactive markets, such as two similarly situated buildings in a downtown real estate market.
- Level 3 are unobservable inputs to be used in situations where markets do not exist or are illiquid such as the present credit crisis. At this point, fair market valuation becomes highly subjective.

# How should alternative investments be accounted for?



The change in fair market value of alternative investments will be shown in the statements of activities as a change in net assets. Thus, the high level of subjectivity of Level 3 investments could materially impact such a statement. Since external users rely on these statements, the impact of this adjustment could impact a user's decision relative to the not-for-profit (such as the renewal of debt).

# How should alternative investments be accounted for?

## Unobservable inputs:

- Should be developed based on the best information available in the circumstances, which might include the reporting entity's own data. In developing unobservable inputs, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions. However, the reporting entity shall not ignore information about market participation assumptions that is reasonably available *without under cost and effort*. Therefore, the reporting entity's own data used to develop unobservable inputs should be adjusted if information is reasonably available without undue cost and effort that indicates that market participants would use different assumptions.

# What are the nonprofit's responsibilities for the support of the fair value of alternative investments?

- The existence and valuation of an alternative investment is the responsibility of the investor entity's management.
- Management of the investor entity that uses audited financial statements or other information as support for the valuation of an alternative investment must be prepared to take responsibility, in its own right, for the valuation.

# What are the nonprofit's responsibilities for the support of the fair value of alternative investments?

Management of the investor entity is responsible for initial due diligence as well as on-going monitoring of an entity's alternative investments and, thus, should consider the degree of transparency before moving forward with the purchase of an alternative investment.

# What are the nonprofit's responsibilities for the support of the fair value of alternative investments?

Illustrative documentation for selection, evaluation, and approval of investee fund manager:

- Written due diligence memos, with appropriate review and approvals indicated.
- Formal due diligence checklists/questionnaires, with appropriate review and approvals indicated.
- Written minutes of meetings where investment decisions were made.

# What are the nonprofit's responsibilities for the support of the fair value of alternative investments?

Illustrative documentation for periodic visits or phone calls to investee fund managers:

- Written documentation of visits to or discussions with investee fund managers.

# What are the nonprofit's responsibilities for the support of the fair value of alternative investments?

Illustrative documentation for asset allocations and valuations:

- Written policy that has been adopted/approved by the Investment Committee.
- Written evidence that policy exceptions were presented to the committee for acknowledgement.

# What are the nonprofit's responsibilities for the support of the fair value of alternative investments?

Illustrative documentation for asset allocations and valuations:

- Written checklists that may address:
  - (a) reconciliation of audited financial statements to recorded balance,
  - (b) rollforward of audited balance from investee fund's year end to investor entity's year end, and
  - (c) comparison of actual returns to benchmarks, and explanations of significant variances.

# What are the nonprofit's responsibilities for the support of the fair value of alternative investments?

Illustrative documentation for review of valuations prepared by investee fund managers, including review of portfolio holdings, key methodologies, inputs and assumptions used.

- Written notes on valuations or separate memo documenting understanding of the investee fund manager's process and conclusions.
- Memo explaining rationale for acceptance of investee fund manager's valuations or adjustments deemed appropriate.

# Can a nonprofit outsource its responsibilities relative to alternative investments?



Quote from AICPA Practice Aid:

“Management of the investor entity is responsible for the valuation of alternative investment amounts as presented in the investor entity’s financial statements” and that “this responsibility cannot, under any circumstances, be outsourced or assigned to a party outside of the investor entity’s management.”

# Can a nonprofit outsource its responsibilities relative to alternative investments?



The investor entity's management may look to the investee fund manager for the mechanics of the valuation or to certain third parties to assist with the due diligence and ongoing monitoring efforts, management of the investor entity must have sufficient understanding and supporting information to evaluate and either accept or independently challenge the investee fund's valuation.

# What are some best practices for alternative investments?

- Boards should provide direction for allocation of the overall investment portfolio and the risk tolerance.
- Boards should provide guidelines as to the required reporting of an entity's alternative investments (e.g., require annual audited financial statements, quarterly internal statements, etc.).
- Boards should provide guidelines as to the type of acceptable alternative investments.

# What are the tax implications and potential pitfalls of alternative investments?

- Unrelated Business Taxable Income (UBTI)
  - When an organization exempt from Federal income tax invests in a partnership, the partnership's activities retain their character, and must be analyzed as though the exempt organization conducted them directly.
  - Frequently, it is partnership activity unrelated to the exempt purpose or debt financing by the partnership that generates UBTI.
  - Corporate netting rules for ordinary and capital gain income apply.
  - A majority of states impose tax on UBTI.

# What are the tax implications and potential pitfalls of alternative investments?



- Additional Reporting Requirements
  - Transfers from a tax exempt organization to a foreign corporation are reported on *Form 926, Return by a U.S. Transferor of Property to a Foreign Corporation*.
  - Transfers from a tax exempt organization to a foreign partnership are reported on *Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships*.
  - Acquisition by a tax exempt organization stock in a foreign corporation may require the filing of *Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations*.
  - Financial interests exceeding \$10,000 in foreign financial accounts, including securities, must be reported on *Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts*.
  - “Reportable Transactions” undertaken at the partnership level can sometimes impose additional reporting requirements at the partner level, including *Form 8886, Reportable Transaction Disclosure Statement*.
  - *Form 8271, Investor Reporting of Tax Shelter Registration Number* is obsolete and has no replacement.



# ***Nonprofit Organizations***

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