

Audit of hedge funds – complexities & challenges

Hedge funds are a type of investment vehicle that pools money from accredited investors and uses various strategies to generate returns. Due to their complex nature and the potential for high-risk investments, hedge funds are subject to strict regulatory oversight, audit being a key component of such oversight. Normally, hedge funds are structured as Single entity fund, Master feeder fund, Parallel fund or Fund of funds.

Audit Processes & Areas

An audit of a hedge fund involves a thorough examination of the financial statements of the fund, its operations and internal controls by an independent auditor. The primary objective of the audit is to provide investors with assurance that the financial information of the fund is accurate, reliable and trustworthy. The audit process for hedge funds is often more complex than that of traditional investment funds due to the diverse range of investments and strategies employed by hedge funds. Hedge fund auditors must have a deep understanding of complex financial instruments, such as derivatives, options and other alternative investments, as well as knowledge of regulatory requirements specific to hedge funds. The audit process typically involves several steps, including:

- **Engagement Planning:** Auditor should conduct engagement planning which includes understanding of the client's business and industry, determining materiality levels and thresholds, develop the audit strategy and plan audit procedures.
- **Evaluation of internal controls:** The auditor will assess the internal controls, policies, and procedures of the

Fund to determine their effectiveness in preventing and detecting errors or fraud.

- **Testing of investment valuations:** Hedge funds often hold complex and illiquid investments, such as derivatives and private equity interests. The auditor will test the valuation of these investments to ensure they are fair and accurate and as per Generally Accepted Accounting Principles (GAAP) of USA.
- **Review of regulatory compliances:** Hedge funds are subject to a variety of regulations, including those related to investment strategies, leverage and disclosure requirements. Verifying compliances with all applicable regulations is an crucial aspect of the audit processes.
- **Review of financial statements:** The auditor will examine the financial statements, including the balance sheet, schedule of investments, income statement and cash flow statement to ensure that they are prepared in accordance with US GAAP.

Amongst others, the following areas hold importance during the audit process:

- **Valuation of investments:** Valuation is a typically complex area due to the 3 different levels that are permitted.
 - **Level 1:** At this level, the assets include listed stocks, bonds, funds or any assets that have a regular mark-to-market (MTM) mechanism for setting a fair market value. These assets are considered to have readily observable transparent prices and therefore a reliable fair market value.
 - **Level 2:** These assets are financial assets and

liabilities that are difficult to value. A fair value can be determined based on other data values or market prices but these assets do not have regular market pricing. Level 2 asset values are sometimes called “mark-to-model” assets. They can be closely approximated using simple models and extrapolation methods. These methods use known, observable prices as parameters.

- **Level 3:** Assets at this level have no observable market prices and cannot be accurately measured using data from current market transactions.
- **Realized & Unrealized gains/loss:** Testing of realized and unrealized gains of a hedge fund involves reviewing the investment portfolio to determine the value of investments that have been realized (sold) and those that are still unrealized (held). This ensures the accuracy of the financial statements and performance reporting.
- **Management fee:** A management fee is a fee that hedge fund managers charge investors for managing their investments in the fund. This fee is typically calculated as a percentage of the assets under management (AUM) and is paid regularly, usually on a quarterly basis. The management fee compensates the hedge fund manager for their expertise, time, and effort in managing the fund, as well as covering operating expenses and salaries. Management fees can vary widely depending on the hedge fund and are typically between 1 to 2 per cent of AUM.
- **Performance fee:** Hedge fund managers typically earn performance fees based on the returns. Auditors must carefully review the calculation of these fees to ensure they are accurate and consistent with the investment objectives of the fund.
- **Net Asset Valuation (NAV):** NAV testing of a hedge fund involves verifying the accuracy of the NAV calculation performed by the fund. Testing the NAV calculation by re-performing key calculations and reconciling them with the fund’s reported NAV is a critical process for the auditor. NAV can also be used as a measure of materiality by the auditor.
- **Related party transactions:** Hedge funds may engage in transactions with related parties, such as the fund manager or affiliated entities. Auditors must scrutinize these transactions to ensure they are conducted at arm’s length and in the best interests of the fund’s investors.

Complexities & Challenges

- **Valuation of assets:** Hedge funds often invest in illiquid or hard-to-value assets, making it difficult to accurately value their holdings. Auditors must carefully review the valuation methods used by the fund to ensure they are reasonable and consistently followed over the years.
- **Complex investment strategies:** Such funds typically use complex investment strategies that may be difficult for auditors to understand and evaluate. Gaining a thorough understanding of these strategies are crucial for the auditor to properly assess the fund’s risk exposure and performance.
- **Regulatory compliances:** Hedge funds are subject to a range of regulatory requirements, including reporting and disclosure obligations. Auditors must ensure that the fund is in compliance with these regulations and that its financial statements are prepared in accordance with relevant accounting standards with full disclosures as required.
- **Fraud risk:** Financial sector is most prone to frauds and Hedge funds are no exception. The complexity of their operations and the high level of discretion given to fund managers make them rather vulnerable. Auditors must be alert to the risk of fraud and take build in appropriate process during the audit planning stages to detect and prevent such happenings.
- **Limited transparency:** Hedge funds are known for their lack of transparency, which can make it challenging for auditors to obtain the information necessary to conduct a thorough audit.

Conclusion

The audit of hedge funds plays a crucial role in ensuring transparency and accountability in the financial markets. With the independent verification of financial information of a fund, investors can make informed investment decisions. Additionally, regulators rely on audit reports to monitor compliance with regulations and detect any potential misconduct. Due to the complex nature of the sector, the auditors have to ensure complete understanding and knowledge of the financial products, policies and practices in order to efficiently conduct the audit.

Authorised by

Sundeep Gupta
ASA

Karishma V
ASA