Risks of material misstatement: Investment companies

Note: This practice aid is intended to help auditors identify risks of material misstatement (RMM) in accordance with AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. This publication is an *other auditing publication* as defined in AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, Professional Standards). Other auditing publications have no authoritative status; however, they may help you, as an auditor, understand and apply certain auditing standards.

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Instructions

AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, requires that the auditor identify and assess the risks of material misstatement (RMM) at the financial statement level and relevant assertion level for classes of transactions, individual account balances, and disclosures to provide a basis for performing further audit procedures. RMM includes both inherent risk and control risk.

To aid auditors in meeting this requirement, this document includes information that could be useful in assessing RMM for investment companies. **These examples do not include all RMM that could apply or be relevant.**

Refer to the AICPA's *Investment Companies: Audit & Accounting Guide* for further information on auditing clients in this industry.

Inherent risk

Economic conditions in the jurisdictions in which funds invest may affect the auditor's assessment of inherent risks for relevant assertions in investment companies' financial statements. Factors that the auditor could evaluate include:

- local rates of inflation
- government stability
- local tax rules

Control risk

Most investment advisers maintain extensive controls, including the following.

Portfolio management controls

- Separation of portfolio management and trading functions

- *Attribution analysis*, which is an explanation of portfolio performance against a stated benchmark, identifying industry or security exposures that caused the performance difference, to assist management in identifying abnormal items for their own follow up
- *Dispersion analysis*, which is comparing the performance of similar portfolios managed by the same individual or group with an analysis of any outlying performance, to assist management in identifying abnormal items for their own follow up
- Frequent reconciliation of cash and portfolio holdings to custodian records
- Comparison of trade terms to broker confirmation prior to recording the transaction
- Extra level of approval for nonstandard wire transfers
- Monitoring of activity on dormant shareholder accounts
- Review of nonstandard journal entries

Controls over valuation of securities not traded on active markets

- Written valuation policies and procedures
- Valuation committees comprising accounting, portfolio management, and administrative or legal personnel to assess valuation procedures and significant valuation estimates. Some registered investment companies place such committees under the oversight of the board of directors or trustees, or both, and occasionally, board members will participate in committee deliberations on significant matters
- Tracking of actual sale prices against valuations as determined by management or market makers
- Use of secondary pricing services for comparison with the primary source
- "Stale price" and "large price change" reports to identify securities for which prices may not have been updated on a timely basis or that have experienced unusual or abnormal changes
- Segregation of portfolio management from valuation functions

Controls to prevent, deter and detect fraud

- Code of conduct regarding ethical behavior, compliance with which is typically documented
- Code of ethics regarding personal trading, compliance with which is typically documented
- Compliance programs
- Periodic documentation of compliance of an investment company with its investment objectives and restrictions
- Systems controls, such as security access
- Channels available for employees to report any fraud concerns

RMM due to fraud

In the investment company industry, the following unusual or unexpected relationships may indicate a material misstatement due to fraud:

- Investment performance substantially higher (or lower) when compared with industry peers or other relevant benchmarks, which cannot be readily attributed to the performance of specific securities when prices are readily available in an active market. Particular considerations include the following:
    - Significant gains (or losses) from securities held for extremely short periods of time
    - Significant gains (or losses) from instruments not typically acquired by the fund
- Unusually high levels of investment purchases and sales in relation to total fund net assets without apparent economic purpose.
- A net investment income ratio substantially higher than the industry peers or other relevant benchmarks, particularly in a fund marketed with the objective of making current income distributions.
- Expense ratios that change significantly from year to year with inadequate explanation.

- Expense ratios and transaction costs exceed industry norms.
- Significant differences between the prices at which securities are sold to third parties from the values reflected in the fund’s net asset value in the days prior to the sale.
- Unusually high volumes of gross fund share sales and redemptions in relation to total shares outstanding.

Fair valuation

The fact that significant amounts of investments are valued by management, either judgmentally or through valuation models, presents a number of risks that the auditor should address. The following are illustrative risk factors related to the fair valuation of investments that the auditor could consider:

- Lack of approval or oversight, or both, of a fair valuation policy by the board of directors or trustees
- Lack of specificity in a fair valuation policy and procedures
- Lack of consistency in the application of valuation procedures
- Inordinate influence of portfolio management personnel over fair valuation decisions
- Fair valuation by management when market values appear to be reasonably available
- Lack of monitoring or follow up, or both, of fair valuation actions taken
- Lack of evidence for fair valuation decisions made
- Significant amounts of investments traded in "thin" markets, particularly through one market maker (either exclusively or primarily)
- For securities not traded in organized markets (in particular, private placements) a determination of whether a purchase of investments has occurred, requiring the initiation of valuation procedures, or whether a sale has occurred for recognition of realized gain or loss, or both
- Increases in the value of investments valued by management shortly after their acquisition without adequate explanation of the circumstances

Daily market valuation

Risks that the auditor could consider include the following:

- Use of a pricing service with inadequate capabilities or controls
- Ability of portfolio management or other unauthorized individuals to override prices
- Lack of consideration or availability of secondary or comparative, or both, pricing sources
- Significant levels of pricing from brokers
- Manual entry or override of prices

Derivative instruments

Derivative instruments are another class of transactions characterized by high inherent risk. The auditor could consider the following risk factors associated with derivatives:

- Lack of a policy governing derivative investments, including a clear definition of derivatives
- Lack of oversight over the use of derivative investments, including an ongoing risk assessment of derivative instruments
- Lack of adequate procedures to value derivatives
- Lack of an awareness or understanding of derivative transactions on the part of senior management or the board of directors or trustees

Trading of investment securities

Trading of investment securities also poses some risks that could include the following factors:

- Lack of segregation of duties between portfolio management and trading functions
- Lack of a developed and consistently applied and enforced trade allocation policy

- Trading through unapproved counterparties
- Lack of enforcement of a personal trading (code of ethics) policy
- Lack of monitoring of commission levels and volume of trading by a broker

Transfer agency and capital stock activity

The auditor could consider the following factors for transfer agency or capital stock activity, or both:

- High volume of cancel, rebook, or "as-of" activity
- Credible shareholder complaints
- Activity on dormant accounts
- Inadequate segregation of duties among mail processing, transaction processing, and reconciliation functions
- Inadequate segregation of duties within transaction processing, such as allowing processors to change an address or banking instructions and initiate a redemption

Other areas involving high degree of management judgment

- Income recognition on high-yield debt instruments when collectability is in question or on asset-backed securities requiring significant estimates regarding the timing of expected cash flows
- Major judgments made in determining that a regulated investment company (RIC) has qualified for "pass-through" status under IRC Subchapter M, which may include determining issuers for diversification status, major determinations of classification of revenue items as ordinary income or (long-term) realized gain, and satisfaction of the minimum distribution requirement
- Significant elements of incentive fee computations (including the computation of any benchmarks against which performance is to be measured)

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