

Financial Services

The next stage of governance

The internal audit function

by Shannon J. Urban

Whether driven by the demands of potential or existing investors, regulators or strategic direction of the organization, hedge funds and private equity firms are exploring new activities and functions to enhance their governance models, such as operational risk management, financial controls (SOX and SAS 70) and internal audit. In this article, we will explore some of the drivers for more robust governance and, specifically, what role internal audit can play in these organizations. We will also share some considerations and challenges for alternative asset managers to think about when establishing an internal audit function for the firm.

Focus on governance

Alternative asset managers have historically operated largely as entrepreneurial organizations with rapid growth strategies. Above average returns in recent years attracted increased attention from institutional investors looking to diversify. Institutional asset flows exceeded \$734b into hedge funds and \$494b into private equity funds in 2007. With the onset of the credit crisis and continuing challenging market conditions, alternative asset managers must work harder to both attract and retain assets. The pressures for transparency, further disclosure and greater scrutiny of risk management procedures are mounting. Investors have higher expectations for firms and business models will need to adapt to weather the storm and emerge strong.

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As an example, firms continue to receive inquiries from potential investors around the globe for information on compliance programs, structure of boards and internal control structures. Current market conditions and regulatory demands have also heightened attention to the need for strong governance and risk management structures in alternative firms. The pressures have also led to standard-setting bodies proposing adoption of leading practices for hedge fund governance across the industry.

In fact, many organizations have begun to mature and adopt more “institutionalized” structures and formalized internal operations. Alternative firms on the forefront of this new environment have started building monitoring and governance structures, including audit committees and compliance departments, and they have also begun to build operational risk management and internal audit functions that did not exist before. In addition, third party reporting (for example, SAS 70), which has historically been the domain of the industry’s service providers, is gaining in momentum as investors are looking for independent assurance on a fund manager’s control environment. Some firms are using SAS 70 as a first step in performing detailed audits over their investment management and fund administration operations that would be complementary in scope and execution to an internal audit.

Why would your firm need an internal audit function? Many alternative asset managers are facing an expanding and more complex risk profile resulting from

their business strategies and models. A number of factors are raising the level of risk exposure, including: pressure on traditional prime brokers and use of alternate relationships, new products and channels, valuation challenges, expansion to international markets, increasingly complex and costly IT investments, expanding third-party relationships, additional regulatory requirements and transaction activity. Strategic direction, such as a public offering or launch of listed funds, also introduces additional regulatory complexities and requirements that internal audit is well positioned to support.

So what value does internal audit bring? Internal audit can provide a level of assurance to management on the adequacy of processes and controls in the firm to address the broad spectrum of risk beyond just investment risk. According to the Institute of Internal Auditors, “Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes”. Through its dual consulting and assurance roles, internal audit can provide tremendous value to a dynamic organization by focusing on areas of greatest exposure, complex operations and key business initiatives, to validate that the organization is well controlled and operating effectively and efficiently to meet the strategic goals of the firm.

The structure of an internal audit function may look and act differently from firm to firm. Clearly, one size will not fit all. However, there are some key factors that all firms wishing to establish an internal audit function should consider in the areas of organizational structure, people and infrastructure.

Structure and mandate

What should be the reporting structure and mandate for internal audit? Those alternative asset management firms who have begun to set up these functions have typically hired someone to serve as the internal audit director (IAD) and in some cases, that person also serves as the head of operational risk management. This is an executive level position and should be filled by someone with the right balance of industry experience, internal audit and risk background. IADs generally report directly to the audit committee of the board, as well as functionally to the chief financial officer, chief operational officer or General Counsel. This helps to establish the significance of the position - especially where internal audit may be new to the firm's culture and collective experience. The scope of responsibility for internal audit may also vary but, frequently, leading functions include global coverage of operational risk, financial risk/SOX compliance, information technology risk, support for regulatory compliance and strategic risk at the management company level in their mandate. This scope of coverage is developed through conducting at least an annual enterprise-wide risk assessment with significant interaction and input from all aspects of the business to identify where the

areas of highest risk are and where greatest value can be gained. Private equity firms may also consider establishing oversight responsibility for governance at the fund or portfolio company level.

People: should you build or buy your team?

From the 2008 Ernst & Young Global Internal Audit Survey, resources are still the foremost challenge for internal audit functions around the globe. There is a "war for talent" across the profession with firms of all sizes competing for skilled auditors with industry and risk backgrounds. Even in an era of financial downturn, challenges include not only recruiting, but also developing core audit and industry skills and knowledge and retaining a team with the right skills to provide both assurance and consulting activities across the broad mandate of the function. There is also the question of critical mass. How large and diverse of a function would you need to build to support the complexities of your organization, and how much of an investment are you willing to make to build and sustain internal audit? To address these challenges, the majority of alternative firms have chosen to use a teaming model. They have selected a third-party service provider that can bring deep technical, risk and industry experience and fully trained internal audit teams to either serve as or supplement the internal audit group and any internal staff. This model is particularly relevant to complex products and strategies, systems development, information security and IT general controls, and resources to support large scale

programs such as developing valuation committees and processes and managing SOX compliance.

Infrastructure considerations

Establishing an internal audit function requires investments to both establish and sustain the group. Such investments include implementing a consistent methodology and disciplined approach in line with professional standards. Internal auditors also must document their work to support conclusions and recommendations. This requires software tools with functionality to house workpapers, knowledge management, coordinate reports and issue tracking, as well as workflow and resource management. There are many packages available on the market to support an internal audit department's needs, but they must be compatible with and supported by the firm's IT infrastructure. Many third-party internal audit service providers are experienced using multiple internal audit tools.

Clearly, despite the troubled economy, asset outflows and pressure to produce returns, alternative asset managers will need to build robust governance structures in order to meet the future expectations of investors and regulators when the tides turn. An internal audit function focused on areas of highest strategic and operational risk to the firm, can provide valuable insight to management by providing assurance that internal processes and controls are operating to support the firm's long term objectives.

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