Hedge Fund Audits: Scope, Materiality, Audit Opinions and Operational Risk

Audited financial statements from a hedge fund manager are a key tool that should be utilized by investors in performing comprehensive operational due diligence. Often these statements contain a wealth of information about not only the financial position of a particular fund throughout a fiscal year, but also regarding any elections made by the fund, expense levels and the overall opinion of the auditor of the financial statements. These opinions are typically classified into two groups: qualified and unqualified. Unfortunately the danger associated with these qualifications is that an unqualified opinion is often translated in investor's minds to mean everything is ok, whereas a unqualified opinion can translate to everything is not ok, more due diligence required. This everything is ok mentality can often provide investors with a false sense of security. Many investors do not take the time to understand what exactly an auditor is blessing with an unqualified opinion. Effectively, with an unqualified opinion an auditor is stating that the financial statement contain no material misstatements. But who determines what is material and what is not? Above certain minimum standards, the auditor does. This materiality level is often set during the design of the audit plan which also contains a number of opportunities for the auditor to make certain discretionary judgments. With all these qualifications and caveats it is understandable that confusion persists regarding audits. Such confusion can result in investors placing too much reliance on the shoulders of the auditors, while forgoing an independent operational due diligence review of a hedge fund manager. Consequently, it is important that investors overcome several commonly held misconceptions regarding auditor attestations and the work auditors actually perform. Some of the more commonly held misconceptions regarding the work of auditors include:

- An audit consists of a detailed review of every position taken by a hedge fund
- There is no discretion among auditors in designing and implementing an audit plan
- All auditors set the same scope of audit and materiality levels consistently
- Auditors must perform on-site visits with each hedge fund manager they audit
- Auditors must perform a detailed review of hedge fund's counterparties and service providers

While an auditor may adhere, either in part or fully, to the items listed above, investors must remember that above minimum standards mandated by the accounting profession, auditors maintain a certain amount of discretion in designing and implementing an audit plan. Depending upon the nature of the audit engagement, best practice may dictate that different hedge fund strategies and fund structures require more audit scrutiny than others. One point for investors to consider is whether a hedge fund's auditor only adheres to minimum mandated guidelines or goes above and beyond to minimize not only audit risk but to also detect operational risk. The fact that certain accounting rules may not have caught up to a particular hedge fund practice should not serve as an escape hatch for an auditor seeking to dodge the responsibility of broadening the scope of a review or increasing the level of materiality employed in an audit.

While a hedge fund investor may not be able to uncover certain items regarding a specific audit plan (i.e. - level of materiality utilized in a particular audit), it still behooves investors to attempt to ask questions about the audit process and methodology. Going beyond the financial statements in this regard will often provide additional insights into both the quality and comprehensiveness of the auditors work. Additionally, and almost more importantly, investors will likely gain perspective into the involvement and level of oversight exerted by the hedge fund manager on the audit process.

For More Information
Corgentum.com
info@corgentum.com
20 Fleet Street, Jersey City, NJ 07306
Tel. 201-360-2430

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