



Emerging Manager Focus

SMALL IS BEAUTIFUL

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Operation Matters

A Million Dollar Sheet of Paper

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A fund has successfully applied its investment objectives and has substantially beaten the market and its benchmarks, but there is a simple math error on the monthly statement. That lonely single sheet of paper, being the only tangible product an investor receives, is now raising questions about the fund's credibility. Rather than receiving calls of congratulations, administrators and managers now spend time fending off inquiries about back office operations and accounting activities. Unfortunately, this is an all too common scenario.

At month's end, funds tend to focus on portfolio valuation at the expense of reviewing all other aspects that go into creating investor statements. Funds should not kid themselves that having an administrator will solve the problem, because they are also victims to this trap. Nothing causes more investor frustration than restatements, particularly fund of funds, who themselves might have to issue restatements of their own. Of course if a fund does restate, it will invariably mention the cause, and usually by name, opening themselves up to more questions and critiques.

Today many back offices calculate and prepare investor statements through a patchwork of spreadsheets and standalone systems. However, the outlook is not bleak. There are new solutions available on the market that can provide a comprehensive view of investor accounting, unifying both partners and shareholders into one offering and integrating into existing infrastructures. However, in addition to using these software offerings, funds should also review their month-end workflow to identify common pitfalls and evaluate all existing reporting procedures.

Common Mistakes in Investor Reporting

Common areas for miscalculations and mistakes include income allocations, fee calculations, share prices and statement control. Firms must understand these areas in order to gain greater control of their internal accounting environments, reduce timely and costly mistakes and, most importantly, improve investor relations.

Income Allocations

Pitfall #1: The process of distributing investment results to investors can be a deceptively complex procedure. Most of the time income is allocated based on investor capital, however, there are several occasions when an alternative method is used. For example, dividend withholding tax is based upon the percentage of foreign investors, so naturally the expense should be allocated only to them. If during the month-end processing all income is blindly allocated based upon capital, and a “special allocation method” is not applied, then domestic investors will unfairly shoulder the burden of the expense. If the amount given to the domestic investors becomes material, then you may need to issue restated statements, correcting the error.

The Solution: Although verifying the total income is a crucial month-end step, a fund must also review what comprises this income. For each category of income, determine if it pertains to all investors or a special group of investors. This simple scan will reveal whether a portion of the income needs to be specially allocated or whether it can be lumped along with the other income and allocated based on capital. An added benefit of the exercise is that a fund is not only just segregating income, but also at the same time, determining who should receive it.

Fee Calculations

Pitfall #2: A fund’s offering document might state that performance fees are simply 20 percent, but fee computations are another common pitfall. Offering documents typically have provisions that let managers waive or reduce the fee at their discretion. It is also common during a fund’s startup phase that a manager can use this provision to offer strategic investors a reduced rate. Now, the calculation becomes less straightforward – combine that complexity of tiered rates with a loss carry forward or, even worse, a hurdle rate, and a handheld calculator no longer suffices.

The Solution: The most comprehensive way to ensure that all fees are correct is to recalculate every investor on a monthly basis. However, if a fund does not have the resources to support individual calculations, sampling a few investors from each class and recalculating both their management and performance fees, is a tried and true method of catching mistakes. Ensure that the correct rate for the class is being used for management fees. Also, verify the methodology used to pro-rate the monthly fee. Often, this is overlooked, and while common methods are 30/360 or actual/actual, mistakes are made where administrators have taken 30/365, thus ensuring that the management company never receives five days worth of fee each year. The calculation complexity increases for the performance fees, and so does the room for errors. Review the basics first, such as: is all income included for the fee’s base and is the correct rate being used for the class. Then, depending upon your offering documents and the sophistication of the fee, ask the following questions: Was there any existing loss carry forward taken into account? Was the correct rate used for the hurdle? Is there a claw-back in affect that alters the fee rate?

Also review any withdrawals, since they can affect the performance fee calculation. It is a common practice to charge a portion of the accumulated fee to shareholders partially withdrawing or partners fully withdrawing. When such events occur, check to make sure the

fee was properly charged. If the fund is in a loss carry forward position, ensure that the carry forward was reduced by the percentage of the capital redeemed. These practices will not only reduce the likelihood for restatements, but will also confirm that the investment manager is properly compensated.

Share Prices

Pitfall # 3: Using the correct share price for contributing shareholders is another overlooked quagmire. A widely-used industry formula for determining the number of shares subscribed is to take the total amount being contributed and dividing by the prior month's per share gross asset value (which is the value of the fund before performance fees). There are unfortunately many per share values floating around – the net asset value (net of performance fees), which is the most commonly used to report fund performance, and the initial share price, which is presented on the offering document. Combine the net asset value and the initial share price with more than one share class, such as new issue income eligible and ineligible, and a fund will have multiple gross and net asset values.

With so many different prices around, it's understandable why the people processing the contribution are likely to use the wrong value. Not surprisingly, this being such a common error, some administrators have, in essence, given up and recommend using only the initial share price, as stated in the offering document.

The Solution: The share price pitfall falls into the class of month-end problems that is actually a result of mistakes made 30 days prior, at the beginning of the month. These issues include using the wrong subscription price for shareholder contributions, putting investors into the wrong investor class, and fees incorrectly charged on investor assignments. An additional complication arises when these issues are caught during the month-end process, since many administrators have already sent investors confirmations with the wrong amounts. So even if you catch the issue, a fund can question its investor as to why the confirmation disagrees with the monthly statement.

While it is all too common to relax once investor statements are sent, funds can stay diligent by modifying procedures to immediately review subsequent capital activity, saving administrators much heartache at the end of the month.

Statement Content

Pitfall #4-5: This is a two-fold pitfall that can only be found by examining the monthly documents themselves. First is the performance calculation. While many statements will include some values indicating the return for the period, that return is typically not shown on the summary accounting reports that are reviewed. Second is the actual verbiage on the statements. Although it seems obvious, there is a tendency to scan the page to review all the values, without truly reading the content. There are many industry horror stories about the “creative” notes and headings that have made their way onto the statements. Remember, this is the single most important correspondence going to a fund's investor. Although all the values on the document are correct, headings like “final notice” will cause the same investor concern that funds try to avoid in the first place.

The Solution: As with fee verification, select a sampling of statements and recalculate the performance. Another good check is to scan all the statements to verify that all the investors in the same class have the same performance. Second, actually read the statements themselves. You'll catch any potentially embarrassing wording. Another reason to read the statements is that most are generated by a CRM or document management system, which is a different system than the one maintaining the investor records, which is typically an accounting package.

Looking Forward

Partnership and shareholder accounting are critical functions for any fund. The good news is that in addition to being vigilante – by knowing the pitfalls and bolstering the month-end procedures – there is a bright light on the horizon. A new breed of software is available that automates these month-end tasks and programmatically avoids the common pitfalls. Also, technology and business vendors are working to better tailor software solutions to meet the demanding investor and monthly reporting activities for hedge funds and emerging managers.

Incorporating technology alongside a fund's best practices for investor reporting greatly decreases the chances of mistakes. These software offerings combine the best of the old partnership and shareholder systems, and have rule based defaults so misallocations fade into accounting folklore. As these systems make their way into the fund infrastructures, the burden of generating consistently correct statements will be just another historic anecdote.

Ron Kashden is president of TKS Solutions, a provider of partnership and shareholder accounting solutions for the financial industry. Kashden has more than 20 years experience in financial services technology and accounting. Most recently, he served as CFO of Tiedemann Investment Group. Prior to Tiedemann, he headed software development for SAC Capital Management. Previously, Kashden worked as vice president of Technology at HedgeWare, Inc. and as a manager of advisory services in a public accounting firm. He is a Certified Public Accountant and holds a B.S. in accounting from Lehigh University.

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