The Case for an Internal Accounting Solution

By: Francis Rainsford, Executive Vice President, VITEOS Fund Services

As the alternative investment industry rebounds from the financial difficulties of the past two years, and faces regulatory reform and increased due diligence from investors there is little doubt fund managers will need to enhance their back offices. Historically fund managers avoided the need for a robust portfolio and fund accounting system by relying on prime broker and administrator reports. It has since become 'best practices' for fund managers to have a portfolio and fund accounting system. Driving this change are; counterparty and operational risk management, operational due diligence by investors, regulatory examinations, increased governance and renewed investor interest in alternatives to traditional fund structures.

This paper explores the challenges, case for and options available to fund managers as they consider an internal accounting solution.

Challenges facing fund managers:

Historically, the industry has taken a simplistic approach to operations. Master feeder funds allowed a fund manager to manage a single investment book, single prime brokers provided the fund manager with everything needed to manage the portfolio, administrators simply facilitated offshore investors into the master fund and investors were merely focused on returns. The rise in investor due diligence, the need for alternative fund structures, and the need for governance processes and regulatory reporting have dramatically changed the landscape in which funds operate and have created a myriad of challenges to the operations of funds.

CFOs and COOs are quick to acknowledge the operational risk associated with the traditional reliance on a prime broker and administrator for post-trade portfolio and fund accounting. To address the operational risk inherent in the traditional model, funds are now evaluating the need for; internal control procedures, internal audits, policy and procedure manuals, SAS 70 audits, and more robust risk and compliance management. 'Best Practices' now dictates funds need to have an integrated back office operation devoid of work around solutions to fill the gaps in processes and technology that result from the absence of a true portfolio accounting system. Without a core portfolio accounting solution providing the data and reporting needed to meet operational risk, it's near impossible for fund managers to address the formal governance processes needed to manage investors' money in today's environment. The challenge now is how to implement a cost effective internal portfolio and fund accounting solution for their business.

The case for an internal accounting solution:

Fund managers need to demonstrate that their back offices are scalable, have the breadth and depth to handle new trading strategies and investment types and can provide the granular level of details that investors and regulatory agencies are demanding. The case for an internal accounting solution is based on the need for:

- Consolidated reporting across all investment vehicles.
- A true portfolio accounting system that can aggregate data across a multitude of funds.
- Accurate, timely and reconciled portfolio reports.
- Net asset valuations and performance reporting other than month end.
- Data that feeds trading, risk and compliance management systems.
- Reducing operational risks associated with mispricing the portfolio, unreconciled trades and inaccurate or incomplete detailed portfolio data.
- Complying with investors due diligence for 'best practices'.

As previously mentioned, the historic simplicity of the structures and operational processes used by fund managers as well as the reliance on prime brokers and administrators mitigated the need for a portfolio accounting system. Today, fund managers and directors recognize that fiduciary responsibility goes well beyond building and managing a portfolio. As with any large company, control procedures need to be in place to safeguard against error and omissions. The industry can no longer afford to manage investors' money in a manner that does not require fiduciary oversight of the post-trade portfolio and fund accounting. The alternative investment industry needs to move to the same high standards used in the mutual fund industry, which has long understood that fiduciary responsibility meant having a formal governance process in place and strong policy and procedures around post-trade portfolio and fund accounting. The dilemma facing the fund manager is how to accomplish this within the frame work of their existing back office and services offered by their fund administrator.

To understand how this dilemma occurred one needs to look at the history behind fund administrators. Fund managers were captive to fund administrators in order to facilitate investing by investors through tax free jurisdictions. Being captive meant there was little motivation for the fund administrators to develop or improve their processes and procedures. The recent financial scandals have cast a dark shadow over fund administrators and the fund managers' operational processes and procedures. The flight to fund administrators is changing to a flight to stronger processes and control procedures in the back office portfolio and fund accounting functions.

The options available for an internal accounting solution:

This section examines and evaluates three options for an internal accounting solution.

- Reliance on fund administrator to provide intra-month reporting.
- Outsource functions around middle and back office that augment and complement the existing back office.
- Buy and build an internal accounting system.

The Reliance Option

Reliance on the existing fund administrator should be the one solution to the problem of not having a post-trade portfolio and fund accounting solution. However, the majority of administrators are ill-equipped to provide intra-month data and reports that are timely, accurate and complete. For many fund administrators, their systems and processes originally were built around month end reporting, and based on antiquated legacy technology and processes that were never designed to provide daily real time reporting. Fund managers are left asking the question, how much true 'value add' is my fund administrator providing to my fund? What fund managers are finding out is quantity of asset under administration does not equate to quality of service. Fund administrators that are focused on daily reconciliation and reporting with the technology and processes that meet the 'proof of concept' will be in greater demand simply because they are creating value add (such as mitigating operational risk, better collateral management and more accurate, reliable and timely reporting) in the back office operations of funds. Administrators that do not raise the bar in terms of their processes and procedures will be left behind trying to hold onto the old mantra that funds are captive and therefore they do not need to invest in their own infrastructure. As in any industry, companies that do not recognize the need for change based on the current environment will slowly but surely find it difficult to survive. The benefits of a daily processing fund administrator include:

- More robust reporting and monitoring of the portfolio.
- Identification of trade breaks and pricing issues.
- Greater transparency for investors and fund managers into the positions, realized/unrealized gains and income/expenses of the fund.
- Ability to aggregate data across multi primes and funds.
- Ability to feed trade, risk and compliance systems.
- Reduced overhead for the operations.

The Outsourcing Option

Outsourcing allows a fund manager to leverage a service provider to augment and complement its existing back office operations. Referred to as 'shadow accounting', this option allows a fund manager to implement a solution in as little as 30 days with minimal commitment of human capital and infrastructure resources. By conducting an internal review of the back office processes and control procedures, fund managers are able to identify operational areas (trade reconciliation, collateral management, exposure reporting and securities processing) that are weak and require strengthening that comes from looking to an outsourcing solution. The challenge is executing the business plan with the right service provider that can meet the specific needs of the fund. Remember a fund manager does not necessarily need to outsource its entire operations; the challenge is to build a solution that addresses specific operational control procedures that need to be in place. Utilizing an outsourcing service provider allows the fund manager to leverage the technology and domain expertise of the service provider, thereby insuring a solution is in place that can grow with the business. The benefits of outsourcing are the ability to:

- Meet future operational requirements without building out the existing back office operations.
- Leverage the domain expertise of the service provider.
- Access a proven business solution.
- Customize the service around the specific operational needs.

- Run the back office operations on a 24/5 basis resulting in timely and accurate reporting.

The Buy and Build Option

Buy and build allows a fund manager to control the portfolio accounting function and provides the checks and balances needed to mitigate reliance on a fund administrator. Fund managers do not want their business growth and changing investment strategies to be hindered by shortcomings in their operations. The benefits of owning the process are great but the speed to execute and resources required to implement the solution are problematic. Fund manager find that there is no 'plug and play' software on the market and the available solutions require a great deal of customization to integrate with order management, risk and compliance software. Only the larger fund managers have the human and financial resources to truly buy, implement and build the systems and operations that meet all the formal governance processes required to satisfy the expectations and demands of investors and regulators.

Fund managers who choose this option will say the most successful implementations are ones where an outside end user of the system is engaged to bring forth best thinking to best practices. Engaging a service provider with a proven business model around the portfolio accounting software reduces the time to implement and results in a more robust portfolio and fund accounting system. The advantages are:

- The fund manager owns and controls the data.
- Reliance on service providers is mitigated.
- System can be customized to the specific requirements.

'

Conclusion:

Fund managers can no longer operate their back office operations devoid of a daily portfolio and fund accounting solution. Best practices mandate that fund managers implement a solution that is scalable and which mitigates the operational risks and gaps in their back office operations. Fund managers need to apply the same level of due diligence and fiduciary responsibility when addressing the needs of their back office that investors take during their due diligence process in investing in funds. Funds that can demonstrate the breadth and depth of their back offices will see their assets grow free of questions regarding the accounting for post-trade processing and reporting to investors and regulators.