

Shadow Accounting

An Essential for Emerging Fund Managers

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Why Emerging Fund Managers Need to Consider Fund Accounting

Rising regulatory requirements and increasing transparency requirements by allocators have led to an increased focus and importance on robust back-office processes. Investors are demanding more reports with better detail and quicker delivery times.

One area that is increasingly getting attention is shadow accounting. Shadow accounting is the process of keeping a separate set of fund records to detect mistakes and inconsistencies. For a fund, it could mean verifying an administrator's NAV calculations or replicating all of its accounting records. NAV errors can be due to complex and illiquid securities, forward contract differences, complex fee structures, mis-accounting of corporate actions, and other reasons. Moreover, with the shift of many funds to the multi-prime broker/custodian from a single-prime broker, it has become more important for investment managers to have their own books, reconcile the accounting records, and have a three-way tie-out with the prime brokers and their fund administrator.

Although a third-party administrator can calculate a hedge fund or private equity fund's official NAV, the investment manager retains the ultimate responsibility to provide timely and accurate numbers to their investors. In the past, there have been numerous instances of NAV calculation errors or overvaluing of illiquid securities. This could lead to expensive lawsuits and fines, and reputational damage, which can take years to rectify.

However, mistakes and inconsistencies aren't the only reason why investment managers are increasingly adopting shadow accounting practices. Shadow accounting capability has been recognized to increase transparency, ensure completeness, validate data integrity, and provide greater operational efficiency. Here are some reasons for adopting shadowing practices:

1. **Allocator due diligence:**

Investors are demanding that investment managers validate the fund administrator's accounting reports. In an overcrowded market, a tick on the diligence questionnaire can make all the difference, especially for bigger allocators like pensions and endowments. There is a consensus between all stakeholders, the investors, fund managers, and service providers that the added oversight is worth investing in. It not only fulfills investor demands but also reduces the risk for the investment manager.

2. **Speed of reporting:**

Institutional investors need access to high-quality data in real time, not just at specific intervals. The shadow accounting process allows firms to create and deliver reports without having to wait for the third-party fund administrator to close the books.

3. **Operational efficiency and independence:**

The shadow accounting process mitigates risk for the investment manager, as they are the ones ultimately accountable to investors. Through shadow accounting, any inconsistencies, variances, and mistakes can be discovered early and fixed, and the required changes can be made to the accounting process to avoid issues in the future. In addition, shadow accounting also allows the fund to not be dependent on the fund administrator for information, allowing them the flexibility to move service providers.

In 2013, Bridgewater Associates decided to perform a full shadow of its primary administrator by a third party. In fact, most of the large hedge funds and private equity firms I talked to already have a shadow accounting process. A survey done by E&Y showed that most of the investors surveyed believed that shadow accounting benefits the fund.

To set up a successful shadow accounting solution, objectives must be defined with proper workflow and processes that work for all parties involved - the investment manager, administrator, and prime broker. First, the fund manager needs to choose whether to go for a full shadow accounting or a partial shadow accounting system. The next question is whether they want to build an operating team or have a third party shadow the administrator.

As the name suggests, full shadow accounting replicates the accounting records completely at the portfolio and investor levels.

Partial shadowing reduces a fund's costs by focusing on higher-risk operations. Partial accounting could include anything the fund manager would want, such as the valuation and quantity of illiquid assets, tax lot appraisals/complex fee calculations, and calculations of accrued interest. It could also entail agreeing on daily P&L numbers and verifying cash positions.

Between a decision to build a team in-house and outsource this process, a fund manager can choose to outsource it initially and then decide to build a team in-house once they achieve a certain scale. However, there is an increasing trend among investment managers to outsource non-core business functions and maintain focus on their core competency.

An outsourced provider brings an unbiased, objective viewpoint and know-how on the best practices and provides operating leverage while removing human resource challenges. Outsourcing the non-core function also takes a lot of the pressure off the back office, many of which rely on Excel-based workbooks using power query and tools to monitor and report key figures. As mentioned earlier, even one of the biggest hedge funds in the world decided to have a third-party shadow accounting service provider.

We at TresVista work with private and public market asset managers and have implemented the shadow accounting processes for them, customizing the NAV packs and other operational workflows to their requirements while providing them unbiased opinions and know-how on the best practices. We work as an extended part of our client's team, and as a result, it reduces the turnaround reporting time of the fund managers to its investors.

Our CFO Office Services support asset managers in various activities like fund accounting, management company accounting, SPV accounting, and FP&A. We also work on capital calls and distributions, prepare partner capital account statements, prepare audit packs, audit support, and general bookkeeping.

To summarize, I believe any fund manager looking to move from the lower middle-market to the middle-market segment should implement shadow accounting in order to attract bigger allocators for the next phase of growth and mitigate the risk of inaccuracies in calculations. Using a third-party partner who can work as a part of your operations, like TresVista, equips fund managers with an unbiased opinion, helps maintain focus on their core competency, provides operating leverage, and solves human capital challenges.

TresVista CFO Office Services

NAV Reconciliation and Clearance of Breaks

Reconciliation of Accounting Books and Investment Portfolios

Request Overview

- To calculate the net asset values, interest accrued, management fees
- To compare the values of these parameters in the two sources of accounting books and identifying the reason for such variances
- Perform root cause analysis for the variances in asset values and breaks along with making adjustment entries and updates in transactions causing the breaks
- Publishing the financials and the NAV package for the fund

Final Deliverable and Value Add

- The date, time, and other source of variables like Market price, FX rates vary between Custodians and Administrators causing variances in the Market value of the assets
- These variances were scrutinized individually with an in-depth analysis and then making updates to the NAV report to get a better understanding of the Net asset value
- Analysis and resolution of the variance reduced the turnaround time for the client in publishing the final NAV Reports for their investors

Output Snapshot

	Source 1	Reclass	Adjusted	Source 2	Variance
Net Assets					
Assets					
Invested Cash (excluding Cash equivalents)	11,045,247	-	11,045,247	11,046,414	(1,167)
Securities Owned	5,818,688	-	5,818,688	5,816,658	2,030
Derivatives - Assets	465,465	(50,607)	414,858	404,561	10,297
Reverse Repo - Lend Cash	-	-	-	-	-
Interest receivable	1,202,384	-	1,202,384	1,192,655	9,729
Prepaid Expenses	-	-	-	-	-
Other Assets	1,759,502	-	1,759,502	1,759,396	106
Receivable from Broker	-	-	-	-	-
Total-Assets	20,291,286	-	20,240,679	20,219,684	20,995
Liabilities					
Securities sold not yet purchased	-	-	-	-	-
Derivatives - Liabilities	(287,352)	287,352	-	-	-
Repo - Borrow Cash	-	-	-	-	-
Legal Fee Payable	-	-	-	-	-
Management fee payable	(237,745)	-	(237,745)	(237,745)	-
Performance fee payable	-	-	-	-	-
Total-Liabilities	(525,097)	287,352	(237,745)	(237,745)	-
Total-Net Assets	19,766,189	287,352.00	20,002,934	19,981,939	20,995

	MV			Accrued Interest			Notional			Price		
	Source 1 MV	Source 2 MV	MV Var	Source 2 AI	Source 2 AI	AI Var	Source 2 Qty	Source 2 Qty	Qty Var	Source 2 Price	Source 2 Price	Price Var
Securities	5,818,688	5,816,658	2,030	39,242	39,384	(142)	248,700	248,700	-	1,144	1,144	-
Bond 1	239,465	246,512	(7,047)	3,306	3,260	46	10,000	10,000	-	94	94	-
Bond 2	963,925	939,586	24,339	7,180	7,334	(154)	1,200	1,200	-	98	98	-
Bond 3	196,559	204,362	(7,803)	3,654	3,817	(163)	3,300	3,300	-	93	93	-
Bond 4	28,027	29,269	(1,242)	1,000	1,020	(20)	1,500	1,500	-	93	93	-
Bond 5	87,499	83,321	4,178	762	740	22	110,000	110,000	-	98	98	-
Bond 6	787,096	754,744	32,352	8,968	8,600	368	14,500	14,500	-	98	98	-
Bond 7	440,651	455,020	(14,369)	3,790	3,957	(167)	30,000	30,000	-	98	98	-
Bond 8	600,629	590,911	9,718	3,057	3,124	(67)	5,700	5,700	-	99	99	-
Bond 9	721,873	756,112	(34,239)	3,019	2,954	65	20,000	20,000	-	90	90	-
Bond 10	336,574	347,208	(10,634)	1,893	1,901	(8)	12,500	12,500	-	93	93	-
Bond 11	851,270	855,828	(4,558)	2,572	2,634	(62)	25,000	25,000	-	92	92	-
Bond 12	565,120	553,785	11,335	41	43	(2)	15,000	15,000	-	98	98	-
Cash & Cash Equivalents	1,759,502	1,759,396	106	39	-	39	2,759,701	2,759,535	166	100	100	(0)
Currency	852,839	852,796	43	-	-	-	-	-	-	-	-	-
Money Market Fund	906,663	906,600	63	39	-	39	2,759,701	2,759,535	166	100	100	(0)
FX Forwards	(465,465)	(404,561)	(60,904)	-	-	-	6,070,014	6,070,014	-	100	99	1
FX	(465,465)	(404,561)	(60,904)	-	-	-	6,070,014	6,070,014	-	100	99	1
Grand Total	7,112,725	7,171,493	(58,768)	39,281	39,384	(103)	9,078,415	9,078,249	166	1,344	1,343	1

TresVista provided an effective analysis into the variances between the two accounting books that helps in analyzing the NAV better.

Fund Fees Entries

Preparing the Fund Fees Entries

Request Overview

- To pass the interest, commission, future brokerage expenses entries in the internal books after extracting these expenses manually from custodian expense statements
- To prepare a statement with the details such as entering the account name, account type, fund name, category and amount of expense and make the entries based on these records

Final Deliverable and Value Add

- Developed a power query table wherein we entered the nature and the amount of expense from the custodian reports
- The power pivot table provides us the journal entry with the relevant account to be debited and credited with the correct amount
- Reduced the overall turnaround time to complete the NAV pack and also increases the accuracy because of lesser manual intervention

Output Snapshot

Fund	Account	Account Number	Date	Currency	Expense Head	Total Expense	Geneva Head
ABC	Futures	12345ABC	4/25/2023	USD	Interest	(3,390.43)	III-InterestExpense
ABC	Futures	12345ABC	4/25/2023	USD	Interest	7,580.00	III-InterestIncome
DEF	OTC	1234ABC	4/25/2023	AUD	Interest	405.42	III-InterestIncomeCollateral
ABC	Futures	12345ABC	4/25/2023	EUR	Commission	(3,050.13)	III-Commissions
DEF	OTC	1234ABC	4/25/2023	USD	Custody Fees	(22,368.33)	III-FuturesBrokerageExpense
DEF	OTC	1234ABC	4/25/2023	JPY	Interest	(41,731.00)	III-InterestExpenseCollateral

RecordAction	Portfolio	LocationAccount	Investment	SettleDate	Debit	Credit	Value
New	ABC	Morgan Stanley-FCM Futures Clearing-Cash	USD-Commissions	4/25/2023		3,390.43	OnHand
					3,390.43		III-InterestExpense
New	ABC	Morgan Stanley-FCM Futures Clearing-Cash	USD-Commissions	4/25/2023	7,580.00		OnHand
						7,580.00	III-InterestIncome
New	DEF	Morgan Stanley-FCM OTC Clearing-Cash	AUD-FuturesBrokerageExpense	4/25/2023	405.42		OnHand
						405.42	III-InterestIncomeCollateral
New	ABC	Morgan Stanley-FCM Futures Clearing-Cash	EUR-Commissions	4/25/2023		3,050.13	OnHand
					3,050.13		III-Commissions
New	DEF	Morgan Stanley-FCM OTC Clearing-Cash	USD-FuturesBrokerageExpense	4/25/2023	22,368.33		OnHand
					22,368.33		III-FuturesBrokerageExpense
New	DEF	Morgan Stanley-FCM OTC Clearing-Cash	JPY-FuturesBrokerageExpense	4/25/2023		41,731.00	OnHand
					41,731.00		III-InterestExpenseCollateral

TresVista provided an efficient process of completing the NAV packs with checks and balances in place.

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