FAMILY OFFICE & FUND ACCOUNTING AT THE ABYSS

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INTRODUCTION - THE CASE FOR CHANGE

The expanding universe of alternative investments is accelerating the use of investment partnerships and the need for Fund/Partnership accounting within the Family Office.

Traditionally, recording data for a fund or partnership and then tracking and reporting on it, starts small and is managed by someone like the office CFO using spreadsheets. However, the inevitable and incremental growth in the use of this investment type has caused the spreadsheet model to grow in complexity. This has brought to the forefront the inherent limitations of using the spreadsheet model.

Spreadsheets, as we know them, have two key limitations. First, they can be the source of mistakes and result in huge error rates. Secondly, they can cause major problems when it comes to audit and compliance concerns. Spreadsheets give the user a lot of flexibility, for example, with allocations. However, all the knowledge about how the spreadsheet model works is typically in an individual's head and the lack of transparency and the degree of risk makes this model unsustainable. This way of working is now teetering on the edge of the abyss and must change to include systems integration, controls, and best practices so that Fund/Partnership accounting in a family office can be implicitly trusted.

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It starts by looking at the tools the hard-working staff at a Family Office have at their disposal. The use of spreadsheets and the associated manual processes should be replaced by a state-of-the-art accounting and reporting platform to enable every type of Fund/Partnership to be administered more efficiently, accurately, with less risk, with more security and built-in transparency.

However, not all technology platforms in the Fund/Partnership accounting space are created equal. Many products use outdated technology, and their limited, stand-alone capabilities cause inherent constraints.

In 2015, the Family Office Exchange defined a best practice regarding technology for a Family Office in their white paper – Technology in the Family Office – Navigating New Solutions. The tenets that were set out in this paper organize the foundational principles of making the right technology decision around fund and partnership accounting. They explain that such a platform needs to:

- be integrated
- have embedded best practice business rules
- professionalize processes and workflows for Fund/Partnership accounting and all office operations

Ultimately, with this as the foundation, the required functionality would be built on a single database to create a fully integrated, end-to-end platform. One that allows work done around the Fund/Partnership transactions to automatically flow to areas like cash flow, asset valuations, entity ownership with the attendant reporting. All of this is delivered via the "Cloud" in order to provide "anytime, anywhere" access as well as the business continuity, disaster recovery and security that the Family Office needs.

The transition to a "fit-for-purpose" platform can be a challenge for a Family Office and choosing the right technology partner is imperative, from defining necessary requirements all the way through to managing the implementation. Once a Family Office implements an integrated platform, the reliance and risk on key staff goes away because things like workflow and calculations are transparent and repeatable by others. It also takes away much of the mundane work from the Family Office staff because they now have the right tools as well as data they can trust.

WHY THE ABYSS?

Spreadsheets are ubiquitous and central to the financial operations of many offices and they are a tool that has contributed enormously to productivity in business management. However, their primary purpose is for analytics and should not be used as a data store or database. It is easy to find statistics stating that 90 percent of spreadsheets contain some type of error, as well as anecdotal stories citing errors that cost millions of dollars.

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Family Offices notoriously use a "Spreadsheet Farm" and are in "Excel Hell" therefore placing them on the edge of "The Abyss" with problems such as:

- Errors in input, formula specification, and import/export definition
- Designed by end users who have little or none of the required technical training
- Very basic security, version control, testing, documentation, and auditability
- Replication of existing Fund/Partnership spreadsheets only adds to problems and inconsistencies
- No distinction between data, logic, and process. A single number used in a management report may appear in hundreds of spreadsheets. If its value, or a formula computing the value, changes then it needs to be changed everywhere
- The "processes" around a critical spreadsheet further complicates testing and maintenance

What about the use of other software?
A typical scenario in a Family Office is that spreadsheets are used together with a portfolio reporting system and some general ledger accounting software. In the past, "workarounds" were devised to try and use other software, like portfolio reporting software Advent Axys, for elements of fund accounting. This often caused more problems than it solved. Like spreadsheet models, how it actually "worked" was in one person's head and created risk and transparency issues.

What about the uses of a dedicated fund accounting software package?
This would be moving in the right direction and although it is a better tool, it is not integrated with the other software the Family Office uses. When it comes to consolidated reporting, like Net-Worth, the Family Office would again have to resort to a spreadsheet to combine data from multiple sources. In addition, many fund accounting software packages are rather like "black boxes" when it comes to data, tasks, and calculations. They don't allow exporting of data so the user has to re-enter information into the spreadsheets, thereby creating a second set of records and the potential for errors and inconsistencies. The myriad of potential allocations is often a problem because the user does not have full control and visibility.

HOW TO AVOID THE ABYSS

It is important to start with the basics and combine a mixture of approach, process and technology. When you move away from a spreadsheet world why not do it right? Look for a platform that will help you implement best practices for Fund/Partnership accounting and continue to grow and address your evolving needs.

What best practices does the Family Office client expect?

- Clear and concise reporting that they can understand
- Deliver and/or explain performance
- Access to information from a single consolidated source of truth
- Office to act in a demonstrable fiduciary capacity

What are the operational best practices needed to meet these expectations?

- An ability to measure quality
- Enabling efficiency
- Ensuring capacity
- Transparency
- Understanding context
- Appreciating impact
- Quantifying value

Of course, the above should be applied to all the activities of a Family Office. Therefore, it is imperative to choose an integrated technology platform where these principles, in addition to Fund/Partnership accounting, are embedded. This choice must be something that goes beyond a policies and procedures manual.

The primary goal is to solve these typical Family Office problems:

- Unreliable data that requires significant investment of manual hours
  - Gathering and scrubbing data every week, month, quarter
  - No structured method of capturing and normalizing data from multiple unique data sources
- Manual business processes subject to human modification and error
  - Limited or highly manual end-to-end risk management processes
  - Lack of audit trails
- Multiple systems with poor or no integration
- Inefficient use of expensive staff:
  - Difficulty hiring and retaining qualified staff
- Poor security and information controls

Operational Best Practice Foundation:

- Data integrity and system-based integration
  - Single database, incorporating all data types, entered once, in a single source of truth
  - No transfer and reconciliation of data among disparate, non-integrated systems
- Best practice process driven throughout (Lean process design)
  - Integrated workflow with audit trails
  - Supporting documentation and entity data integrated into workflows
  - Documentation and entity data available for audit after the fact

- Role and relationship-based secure access
  - Access to each system component, document, message, task, event, data screen, workflow…etc. controlled by a sophisticated permission system
  - Separation of duty enabled through role-based access set up

BEST PRACTICES FOR FUNDS AND ALLOCATIONS

A Family Office will potentially have to deal with a wide variety of fund types and their specific needs:

Hedge Fund style	Regular monthly/quarterly openings for additional capital contribution and/or distributions, with NAV calculation and allocation of change in NAV on monthly basis to Investors based on their current capital balance or units held percentage. Monthly/quarterly management and performance fees allocated to Investors.
Private Equity style	Closed-end approach with single opening, due to lack of mark-to-market of underlying investment(s), there is limited need for periodic change in NAV allocations. Periodic allocation to Investors of investment and/or management expenses with subsequent capital calls to Investors and initial percentages.
Real Estate style	Like PE style, but may have periodic ordinary income/expense from leasing or other operations to be allocated and distributed to Investors on monthly/quarterly basis.
Multi-tranche style	For any fund type that has multiple tranches, series or classes as a single legal entity.
Funds with Side Pockets	For any fund type that requires segregation of assets by various investor pools within a single legal entity, in order to allocate results of a group of assets to a specific investor pool at each investors percentage of the pool, rather than percent of total fund.
Money Market style	Fund allowing capital contributions/distributions daily, with change in NAV allocated to Investors monthly based on weighted average capital balance during the month.
Hybrid	Fund providing for different components of change in NAV to be allocated at separate percentages – such as capital gains allocated on one set of percentages and ordinary income allocated upon another.

Paramount within Family Offices is the Entity Management around fund structures such as partnerships, LLC's, corporations, or other such multi-owner entity types. This work then flows through to the accounting approach, cash or accrual, the accounting calendar, classifications, and the chart of accounts. But perhaps the most important accounting element is the "closing" because of the often unique structure per fund. Here, it is crucial that the closing of funds at different tiers/levels occur simultaneously and in a particular sequence.

The allocation process is a key reason that spreadsheets are used by Family Offices for Fund/Partnership accounting. Any replacement of a spreadsheet needs to be a module that is specifically designed to calculate allocations of all types and create transactions from the results.

Allocations may apply to transactions such as:

- Investor capital contribution or subsequent capital calls based on commitment amounts/percentages
- Investor income or cap gain distributions
- Monthly/quarterly change in NAV
- Tax allocation of components of K1-reportable items (income, gain/loss, etc.)
- And for transactions outside of Fund Accounting:
    - Allocation of expenses across multiple entities or investments
    - Allocation of bank fees/interest from omnibus accounts to internal sub-accounts
    - Allocation of corporate overhead to Entities

The best practice offered through Eton Solutions AtlasFive can do this through using a "controlled" spreadsheet-like functionality. AtlasFive's allocation module uses embedded custom templates to perform the allocation, using spreadsheet-like logic to build the allocation based on existing/reconciled data from integrated ledgers, with the necessary flexibility and control. The spreadsheet-like approach is intuitive for users to understand and learn and the data is in a central consolidated database. So essentially, we end up with the best of both worlds.

Key Benefits of this Approach:

- Easily adapts to your current methods in spreadsheets for allocations. Extremely flexible and able to handle virtually any allocation/computation - this is a tool for business analysts.
- Bullet-proof allocation templates, tied to actual accounting data, which precludes common user-errors such as over-writing formulas and fat-fingering data. Includes error handling, rounding routines and audit trail.
- Templates are built dynamically based on data in the database.
- Transparency into the logic/details of calculations for simplified review/verification (various steps and intermediate calculations are visible as well as the formulas that comprise the allocation logic).
- Date-dynamic – can pull data from the database as of any date for balances, capital percentages, income, etc. Can work in any open GL period.
- Template results saved with workflow for Approver review and year-end audit review. Stored on the platform, with the transaction rather than on someone's individual hard drive.

- Supports notations, attachments, side calculations as needed to document the calculated results.
- Uses Excel functions and custom functions for easy template development.

AltasFive offers a unique integrated solution for Family Offices. It allows work done around the Fund/Partnership transactions to automatically flow to areas like cash flow, asset valuations, entity ownership with the attendant reporting. AtlasFive transforms Family Office operations in terms of transparency, function and value-add.

COVID-19 – THE GREAT DISRUPTOR

The pandemic has been a disrupting force and an accelerator for transparency and the necessity of Family Offices moving away from spreadsheets and manual processes wherever possible. This singular event drove market volatility which catapulted the staff at Family Offices into spending more time and energy on monitoring their portfolios, with a particular focus on exposure to risk.

Family members had daily questions such as:

- How are you allocating resources to support your portfolio companies?
- What are the strategies and assumptions underlying these choices?
- Are you allocating time and resources to explore new investments during the downturn? Where do you see the opportunities?
- What impact do you expect the current uncertainty to have on future valuations?
- How will this impact their liquidity?
- What are the capital activity projections?

Answering questions such as these, when data for Fund/Partnerships is in a spreadsheet is extremely difficult even in the best of times. Add on the pressure of panic and this creates an environment fraught with mistakes. These mistakes can be hidden in the depths of a wrong formula in a spreadsheet and can be very costly and risky.

The need for transparency is not just around Fund/Partnerships but also encompasses how any movement in these areas impacts the big picture of the family wealth in total. All the data a Family Office needs for analysis and to answer family questions is inter-related with all the other data the Family Office is tracking and reporting on. Therefore, a Family Office needs a single source of data, one that captures data from all functional areas and can map it to the entity structure that is the reality for the office.

In a crisis, a family wants active communication and timely accurate data from the Family Office. That is why they have the office: to manage their wealth and provide a single point of contact for questions and actions. But communication is nothing without transparency, clarity, and reliability. Data living in a spreadsheet is the antithesis of that.

CONCLUSION AND KEY TAKEAWAYS

The ability to buy and use an integrated technology platform designed specifically for a Family Office is now a reality. With best practice business rules, processes, and workflows at the core, Eton Solutions' AtlasFive platform offers the strongest foundation available and opens up the most sophisticated route to achieving a modern fund and partnership accounting approach for the Family Office. With AtlasFive you have the familiarity and flexibility of a spreadsheet where you need it, tied to security, risk management and optimized efficiency (business process, workflows, and full audit trail) of a modern integrated technology platform.

Key Takeaways

1. Drive change around Fund/Partnership Accounting with a new technology platform that has a positive impact on this function and the whole office including:
    - More effective and efficient work
    - Maximum flexibility
    - Seamlessness data integration
    - Systemically insured data integrity
    - Full transparency
    - Managing operational risk at the highest level

2. Professionalize your Fund/Partnership Accounting with a technology platform that has embedded, controlled, best practice business processes and workflows.