



A TSC White Paper

How To Speed Up Fund Accounting For Investments

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Summary:	<p>Community foundations face growing pressures to improve investment related services. Clients are looking for daily access to consolidated account information, integrated performance reporting, working partnerships with new financial institutions, and a foundation that can keep up with it.</p> <p>This white paper is targeted at financial staff and their outside advisors who want to meet this challenge head on. It discusses the threat, identifies a strategy to meet it, traces potential problems especially related to month end closing, and recommends actions to mitigate these problems and enable successful solutions.</p>

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I. Speeding Fund Accounting For Investments

1. The Challenge

A. Background

Not too long ago... A typical foundation's operations staff...

- Managed a small number of funds, and invested them in just a few pools.
- Housed these accounts with a primary custodian, and had only a handful of relationships with other financial institutions.
- Awarded donor advised fund grants once or twice a year.
- Closed the accounting periods for investment accounting in a monthly cycle.

Point #1: *Today's foundation operations reflect a past century of practices. The systems that support these policies and procedures are well suited to them.*

Then, change happened...

- Financial service providers took notice of the market for philanthropy, introducing new players into the mix. There was a debate by foundations as to whether these newcomers represented competition, but that debate is over.
- Tax laws were re-written. Evaporated were the incentives that once compelled a donor to find a charity such as a foundation.

Point #2: *A dual threat has emerged where the market space occupied by foundations has been discovered, and traditional advantages no longer apply.*

Despite this challenge, some community foundations are experiencing success: growing their assets, donors served, funds managed, and transactions.

- A key strategy in reaching new donors has been the formation of partnerships with other financial service providers (advisors, brokers, etc).
- The level of service expected by our donors (and grantees) is driven by the established common business practices in use by these partners.
- Higher service levels means faster closing for month ends, availability of daily pricing, faster turn around of deposits & redemptions, transparent reporting systems and availability of comparative performance statistics.

Point #3: *The new standard for operations must meet or exceed the service levels delivered by private financial service providers.*

Bottom Line: There is a disconnect between the way in which foundations traditionally have done their work, the systems that grew to embody it, and the demands of the current market.



B. The Response

Community foundations response to this challenge began in earnest in 1998, undertaking a comprehensive competitive and market research analysis that was delivered in 2000¹. Continuing work led to the formal adoption in November, 2002 of the "Comprehensive Functional Requirements for Community Foundations," better known as the Technology Roadmap². It represented:

"A proposal to support critical technology improvements that build community foundations' current technology readiness, capacity and infrastructure, and that ensure the field's core technology system has the open architecture, flexibility and tools to compete effectively in the philanthropic marketplace of the future".

While the initiative included groups devoted all aspects of capacity, the Seamless Processing committee of the TSC focused on the investment aspects of the business model. Figure 1 presents the finding of this committee:

Figure 1 – Business Drivers and Solutions	
Expectations:	<ul style="list-style-type: none"> The financial services industry has set a high bar for service level expectations: <ul style="list-style-type: none"> - same day trading - data base reporting functionality - institutionally agnostic (anyone welcome) - direct deposit payout
Current reality:	<ul style="list-style-type: none"> Dozens of paper statements are manually scrutinized for irregularities Amounts are manually added together (adding machine or spreadsheet) to consolidate multiple statements into pools used for fund participation. Month end close of investment accounts is a 7-10 day process. Errors stay in suspense until the next monthly closing period. Financial relationships are strictly limited (new brokerages discouraged) due to additional overhead expense.

The Seamless Processing committee went on to identify the following priorities:³

- A capacity to link the core systems in use by Community Foundations to their banks, brokers, investment managers and custodians.
- "Straight through processing" principles and the goal of seamlessly linking front end client delivery systems with back end transaction processing engines.

The committee then set about to find partners to implement these goals.

¹ The Community Foundation Strategic Alliance represented sixteen community foundations and later merged with the Community Foundations of America.

² See Technology Steering Committee (TSC), <http://www.cfamerica.org/page7403.cfm>

³ See Seamless Processing: Business Needs Document, Version 2.0, TSC, December 31, 2003



2. A Sample Solution

In March of 2004, the TSC Seamless Processing committee acted to select American Stock Transfer (AST) and its new division AST Trust to provide the seamless processing solutions for the Technology Initiative. It noted:

*"AST brings to the table a ready-to-use seamless processing solution as well as numerous existing relationships with funds and brokerages around the country."*⁴

The platform provided under this agreement is named *Foundation Partner*. It is a comprehensive web-based service that benefits donors, trustees, and investment consultants. It electronically integrates investment management and custody information to provide timely and accurate reporting. The platform offers the following services:

- Integration of data from multiple custodians into a unified feed to the client.
- Daily collection of transactions and positions, including integrity checks and the research & correction of errors where necessary.
- Unit Pricing of investment pools and mutual fund investments, as well as unitization of investment pools across multiple custodians.
- Scanning of investment statements and secure offsite storage of same.
- Performance reporting for individual accounts as well as groups of accounts, including portfolio analytics, benchmark comparisons, and asset allocations.
- Improved internal controls over investment cash flows through increased transparency of data.

The *Foundation Partner* platform is designed to interface to foundation fund accounting systems using a data schema developed by the TSC. The schema itself provides not only the summary entries needed to allocate such things as income and gains, but it includes data critical to improving controls over investment cash flows, and specifically captures data on corrections made to prior periods, which is essential in fund account reconciliation.

AST has worked with the TSC to refine this schema and made data feeds available for the direct interface to a foundation's fund accounting system⁵. The system includes the capability to generate both monthly and daily files. The monthly files are for use in reconciling the foundation's general ledger (audited). The daily files are for use in operations requiring daily valuations (un-audited).

The timing of when the audited file is produced after month end is set in consultation with each foundation client. This is largely dependent upon the investment mix within underlying accounts. AST is able to provide reconciled month end data at five days past month end (T+5). However, this cutoff can be moved back at the clients discretion to accommodate special circumstances such as hard to price assets.

⁴ For more information on AST Trust, see http://www.asttrustco.com/inv_intra.asp or contact Mike Flinn at mflinn@asttrustco.com.

⁵ AST provides web-services based access to the data needed for this integration. Development of the ability to insert this data into FIMS has been delayed.

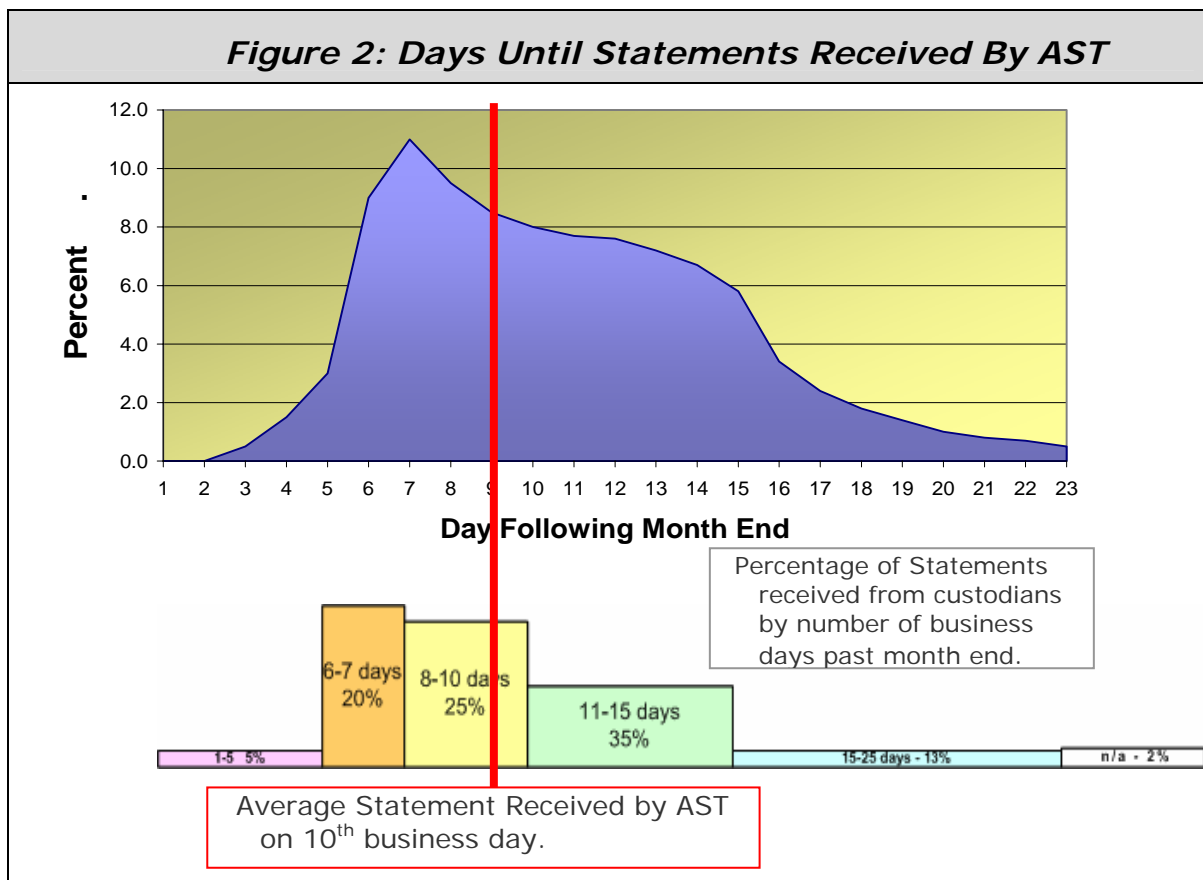


3. Operational Issues

Convinced of need to transform their operations and "meet or exceed the service levels as those delivered by private financial service providers", several foundations have acted to implement the AST Foundation Partner system. To maximize the impact of this experience, the TSC has facilitated an **early adopter** program bringing these foundations together. The early adopter group has been able to provide feedback to AST to further improve the platform, and more importantly has been able to share the internal issues they face.

The **lessons learned** by this group of foundations is still a work in progress, but it is clear that many common internal practices need to be examined by a foundation in order to make the kind of transformation required. These internal issues include:

- Statements don't all come at the same time. This simple reality doesn't matter in a manual world, but as will be seen later, it has a deep impact on when a single consolidating file can be created.
 - The figure below demonstrates this point by showing the distribution of when statements across all custodians are received after month end by AST. While the average is 10 days, the 5-15 day range is prevalent.
 - Earlier statements come from accounts with more common investments. Conversely, the more unusual the mix, the later the statement.





- Faster availability of pricing information exposes hard-to-price assets in the portfolio as requiring special exception handling. Thus exception policies, such as stale pricing, need to be put in place before daily pricing can be achieved.
- Faster month end closing exposes late-reporting investment accounts as requiring special exception handling, as monthly closing would need to proceed before the statements were received. One foundation discovered that the expense of such exception handling resulted in divestment of such assets.
- Early adopters point to a need for advanced planning to insure that custodians be in-network vis-à-vis the AST system. While AST is experienced in setting these up, not all custodians are. A quality relationship with the financial service provider will affect the timing of data and will in turn drive faster pricing & holdings availability for a foundation.
 - Early experience also shows that it will take a couple of month ends for the data feeds from a custodian to settle into a routine.
- The increased availability of data on investment accounts increases the transparency of these accounts...
 - Errors and corrections previously shielded underneath statements are now shown in full.
- Past practices are now questioned, such as the use of statements from the investment manager rather than the custodian for purposes of posting to the general ledger (GL).
- The investment performance subsystem has deep functionality, but setup care must be used so that comparative benchmarks and fees are handled correctly.
- The group is still waiting on the development of the programming on the *FIMS* and *FoundationPower* end to accept the automatic data feeds.
- One of the most profound changes required in transforming a foundation's investment accounting relates to its **reconciliation to the foundation's GL**. This issue is addressed in the following section.

Adoption of the AST *Foundation Partner* platform holds the promise of a radically improved level of investment services for a foundation, but to leverage this promise requires change in existing procedures.



4. Best Practices:

When a community foundation opts to use the Seamless Processing solution offered by AST Trust it represents a major change both in service levels surrounding investments and in the way such investments can be audited.

Problem Statement: *Traditional mechanisms (namely hard copy custodian statements) used to audit investment accounts and specifically used to reconcile entries made to the general ledger for these accounts are **not compatible** with systems designed to deliver a new higher level of service⁶.*

The emphasis “not compatible” in this problem statement is value free: it is not that one is “right” and the other “wrong”, it is simply that they are different. But if an external auditor seeks to reconcile an account using the traditional tools of the trade (statements), they will be challenged to do so. This difference is a material problem. Building a mechanism between these systems is not trivial.

Step #1: Understand current investment account reconciliation procedures.

- Community Foundations and their external auditors have historically relied upon paper statements of investment accounts for the preparation of investment entries into the fund accounting system and the reconciliation of these entries.
- As shown in Figure 2 above, (page 5), paper statements are received throughout the month following a closing, meaning some come in very late.
 - a. This practice provides a buffer period after the end of a period for trades to close and confirmations of valuations to be received. It also allows for the calculation of income accruals (interest earned but not yet paid). This waiting has the effect of making the statement as accurate as possible⁷.
 - b. The more unusual the asset mix within the account, the longer this takes.
- In technical terms, these statements are based upon positions and transactions calculated at varying numbers of days from month end ($T+X$).
 - a. This delay in receiving statements is at the heart of the incompatibility problem. Striking values for foundation’s pools waits for the last statement.

Step #2: Partner with an institution with the credentials and capability to provide a service level competitive to the financial services industry.

- AST Trust Company, a division of American Stock Transfer & Trust Company, operates under the New York State Bank license held by the parent, and is also registered as a transfer agent with the SEC.
 - The AST platform is covered by a third party SAS70 report confirming that its control activities are meeting its stated control objectives. The SAS70 is a level II report and is prepared on an annual basis.

⁶ Where higher service levels means faster closing for month ends, availability of daily pricing, faster turn around of deposits & redemptions, transparent reporting systems and availability of comparative performance statistics

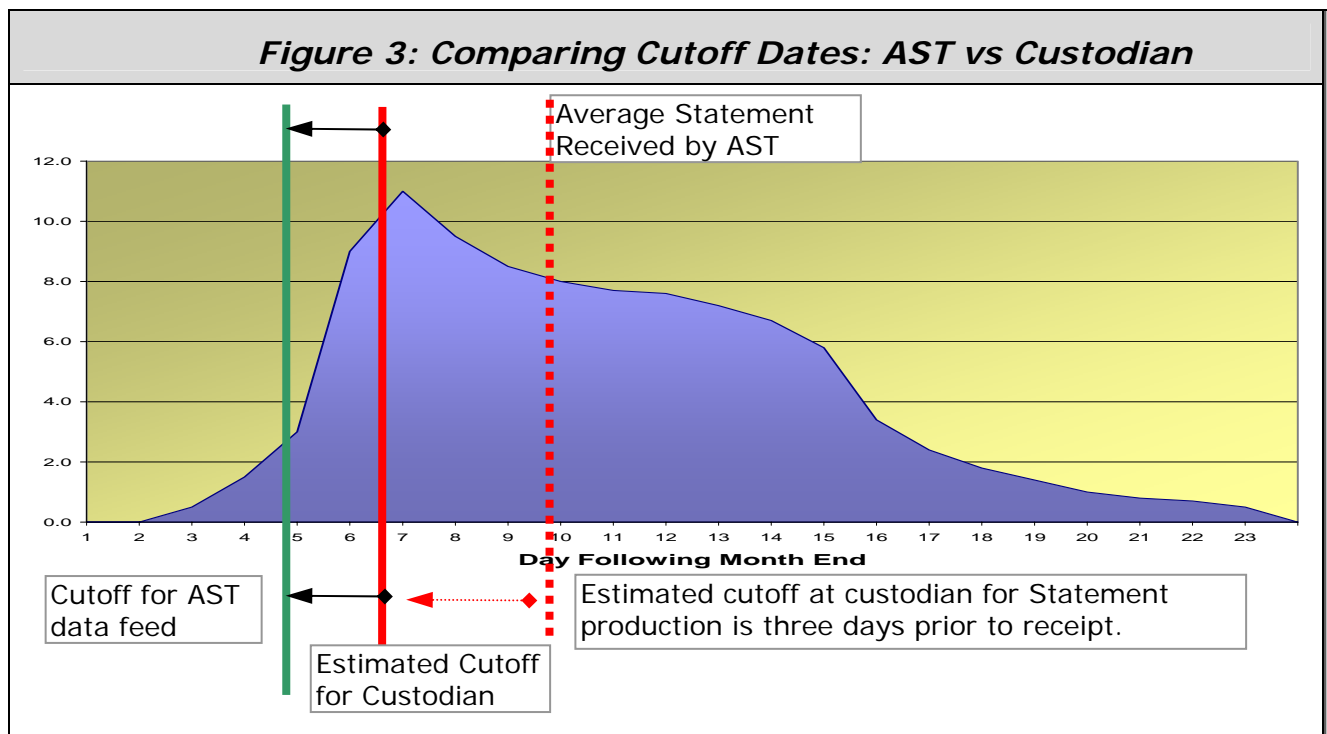
⁷ Note: corrections to prior periods are a common business practice within investment accounting.



- This platform is designed to integrate data from multiple custodians into a unified feed to the client, including daily collection of transactions and positions, integrity checking and the research & correction of errors where necessary.
- The AST platform provides this data on a daily basis for clients requiring daily processing. It also offers a fully reconciled monthly data feed of these transactions and positions within 5 business days of month end (T+5)⁸.

Step #3: Understand the differences between these investment accounting systems.

- A critical difference between the AST based system and the traditional statement based system is one of timing. AST cuts off transactions at (T+5), and a traditional statement are received continuously - indicated here as (T+X).
 - Note that even if a client were to opt for an AST cutoff of (T+7) and if the average statement cutoff (T+X) was 7 days, the AST cutoff would be sooner than late arriving statements.
- Specifically, post-dated corrections to prior period transactions (such as the reversal of a trade, the correction of an income accrual, or the re-pricing of a position) that occur between striking a month-end close at (T+5) versus a (T+X) will create a difference (a set of reconciling items) between the AST data feed and the paper statements.
- In general, such post-dated corrections are de minimus with respect to the administration of the financial statements of a foundation. In the extraordinary event that such a correction would represent a material change to an account, procedures will require AST to notify the foundation of such a change.



⁸ As noted above, a client may choose for this cutoff to be different, e.g. T+10.



Step #4: Learn about the operational mechanism used to handle adjustments.

- During the preparation of a month end data set, the AST platform scans the database for activity that affects a prior period.
 - These post-dated transactions and corrections affecting prior period activity are reported and clearly identified.
 - As the number of investment accounts grows, this ability to isolate reconciling entries will become a major resource.
 - Since such post-dated corrections in fact took place during the month following closing, their inclusion in activity reported within that month is appropriate.

Step #5: Exercise due diligence on the new reconciliation mechanism.

- An external consultant should be engaged to establish an audit of the transition between using statements ($T+X$) to using the data feeds ($T+5$) for the preparation of financial statements. Such a one time audit will establish a full reconciliation between the two, and can be repeated on an annual basis.
- A Foundation staff person (such as an investment officer) may view the full array of investment accounting data at any time using a browser based interface. The *Foundation Partner* website includes the ability to download individual transaction data as well as download “static” monthly/quarterly reports that also provide transactional detail.
- The Foundation’s external auditors may be provided these same facilities in order to carry out their duties.
- The schema used for the data feed provides the information necessary to progress an account from a GL perspective.
 - This schema provides for summary entries for posting directly to the GL.
 - It also includes detail data allowing the foundation to drill into granular information to expand the capabilities of the GL accountant in troubleshooting and custom report writing.
 - It also includes data for internal controls not traditionally found in fund accounting systems, such as *FoundationPower*, *FIMS* or Financial Edge. This includes all investment cash flows and current market values derived straight from the investment portfolio (as opposed to the GL).
- The Foundation will have the capability to view and report on the AST data.

Step #6: Act to adopt Seamless Processing.

- Take action to set the baseline closing date used for investment accounting to five days after month end close ($T+5$), (or whatever interval desired).
- Adopt a policy whereby the Foundation will rely on the AST Trust Company as its agent in reconciling those investment accounts assigned to it under contract.



- Such services are included under Exhibit A of the Administrative Services Agreement, specifically: "Reconcile all positions and cash balances to the Custodial account".
- Take a further action to rely on the integrity of the month end data feed from AST as the basis for the preparation of its financial statements.
- Develop a management procedure to handle exceptions. For instance:
 - Provide for stale pricing when "T+5" valuation is unavailable, such as would be the case for accounts holding hard to price assets.
 - Provide for manual adjustment to entries affected by material changes to prior period transactions as identified by AST⁹.

5. Conclusions:

This white paper has shown how community foundations can be well positioned to improve investment related services and specifically how to change accounting practices to stay ahead of these changes. The paper identified successful strategies to achieve this positioning. It discussed transitional problem areas and recommended actions to ease this transition.

⁹ Note: Such items would reflect a significant change to a prior period transaction that was received after AST closed its cycle and transmitted the data files to the foundation, but before the foundation completed its month end closing.



II. Appendix

1. A Model Policy

1. **Whereas:** AST Trust Company, a division of American Stock Transfer & Trust Company, operates under the New York State Bank license held by the parent, and is also registered as a transfer agent with the SEC.
 2. **Whereas:** Adoption of the AST Trust *Foundation Partner* platform ("AST") offers numerous benefits to its clients which include:
 - Integration of data from multiple custodians into a unified feed to the client.
 - Daily collection of transactions and positions, including integrity checks and the research & correction of errors where necessary.
 - Unit Pricing of investment pools and mutual fund investments, as well as unitization of investment pools across multiple custodians.
 - Scanning of investment statements and secure offsite storage of same.
 - Performance reporting for individual accounts as well as groups of accounts, including portfolio analytics, benchmark comparisons, and asset allocations.
 - Improved internal controls over investment cash flows through increased transparency of data.
 3. **Whereas:** the AST platform provides a fully reconciled monthly data feed of these transactions and positions within 5 business days of month end (T+5).
 4. **Whereas:** the AST platform is covered by a third party SAS70 report confirming that its control activities are meeting its stated control objectives.
 5. **Whereas:** an external consultant engagement is available to establish an audit of the transition between using traditional statements received throughout the month (T+X) to using the data feeds (T+5) for the preparation of financial statements, and that whereas such an audit will establish a full reconciliation between the two.
 6. **Whereas:** the Foundation has robust abilities for staff and external auditors to view the account data both online and within the schema used for the data feed used to prepare GL entries.
- A. Be it therefore resolved:** the Foundation hereby acts to set the baseline closing date used for investment accounting to five days after month end close (T+5)¹⁰.
- B. Be it further resolved:** the Foundation will rely on the AST Trust Company as its agent in reconciling those investment accounts assigned to it under contract. Such services are included under Exhibit A of the Administrative Services Agreement, specifically: "Reconcile all positions and cash balances to the Custodial account".
- C. Be it further resolved:** the Foundation will rely on the integrity of the month end data feed from AST as the basis for the preparation of its financial statements.
- D. Be it further resolved:** the Finance and Audit Committee directs management to develop a procedure to handle exceptions to this policy with regards to pricing and handling of material adjustments to month end closing values.

¹⁰ Exact interval chosen at the discretion of the foundation.