

Accuracy and the Use of Estimates

As our friends in the audit profession often say, "Accounting is an art, not a science." What does that mean? Aren't numbers, well, numbers? Shouldn't they always add up?

What is NAV?

It might be interesting to first consider the point of determining the Net Asset Value – NAV – of a fund. What does it tell those who have a beneficial interest in the fund? Is it a precise report of the fund's liquidation value as of a given date? Or is the NAV merely an approximation of what the liquidation value might be? Is the NAV even intended to be a report of the fund's liquidation value, or is it something entirely different?

Let's consider first the argument that the NAV is intended to report the fund's liquidation value. If so, the expectation would be that, on a given date, the NAV tells the beneficial holders that should all assets be liquidated, all obligations met, that the value to be paid to beneficial holders is "x." Unfortunately, in a hedge fund, there are myriad pieces to the accounting puzzle many of which are not simple absolutes. For example:

- **"Normal" valuations.** Publicly traded securities are usually valued at the price of the last trade on the "Valuation Date" (generally the last business day of the month). But, could a fund have actually sold 10,000 or 100,000 or a million shares at that price? The answer is, at best, "Maybe." Maybe the difference is only a dime or a quarter a share; however, it could be dollars depending on conditions on a particular date. And even if the block could have been executed at the "closing price" used for that day, wouldn't there have been costs to execute the trade? Fund net asset values do not normally attempt to estimate brokerage commissions. What would those costs amount to in an actual liquidation scenario?

- **Valuations of restricted securities.** In addition to the ordinary question of whether a market price reflects what a marginal buyer or seller would actually experience, some securities (such as PIPEs) may be restricted from sale and have formulaic price adjustments until registration.
- **Valuations of illiquid blocks.** Should a block of shares that is large compared to average volume be discounted? Can some large positions command a premium in some situations where others are trying to accumulate the stock? While a premium would be rare, is a discount fair if the fund is experiencing capital additions? If experiencing redemptions?
- **Valuations known to be estimates when received.** In the fund-of-funds space, valuations from underlying hedge funds are frequently estimates which are updated and finalized at a later time. Since investors like to finalize their own records, when does the fund-of-funds declare its results final?
- **Accruals for expenses.** Due to changes in fund activity or a revised bid, an estimate for audit and tax preparation expenses that has been accruing often has to be adjusted late in the year.
- **Error corrections.** All funds will have trade errors that aren't discovered or repaired immediately. In the interim, there can be effects on portfolio valuation.

The bottom line is that, even in a fund comprised of highly liquid stocks, it is unlikely that it could have liquidated on the valuation date with net proceeds within ¼% or ½% (or more) of the NAV determined.

Clearly, at best, the valuation of a fund at any month-end can only be considered an approximation of liquidation value. Liquidation value is not determinable theoretically – it is only precise once the portfolio is in cash.

What is NAV? continued

For a moment, shift to the perspective of a new fund, all in cash, that is looking to create a similar portfolio. Just as the portfolio could not be liquidated at the determined NAV, it could not be purchased in full at those values either. A fund that is a continuing business sells and buys back its portfolio each time new capital is added or redeemed. Practically speaking, therefore, the objective of fund management, the administrator and the auditor is the creation and validation of a reasonable fund net asset value that fairly balances the interests of buyers and sellers – existing static investors plus those who are adding or redeeming capital interests in the fund.

Qualitative Factors

How is a fair and as-close-as-practical valuation achieved? We believe there are four basic ingredients:

- *It is based on reason.* For example, we think “last price” is reasonable because it provides a point in time for measurement, plus the last price does reflect a real-world purchase and sale – at least some shares could realistically have been bought or sold by the fund at that price.
- *Unbiased.* While last prices reflect the serendipity of the mix of bids and offers at today’s close, they are independent of the fund and therefore unbiased. What if quotations of last price differ depending on the source? This may occur, for example, when a brokerage firm price feed differs from that obtained directly from a pricing vendor. If similar, is either more accurate? For practical purposes, what might be important is that pricing all securities from the same source will generally provide the most unbiased number. Conversely, bias can be introduced when someone goes through two price files, picking prices based on which is higher.
- *Not known to be significantly inaccurate.* A last price that is stale, let’s say a week or two old, would be known to be inaccurate. Such a price should be validated using current bids or offers or some other independent source of likely valuation.
- *Consistent.* While pricing methods can change over time as new information is gathered, the general rule is consistency. Again, using the example of last price: on any given day, the last price can be an uptick, downtick, or the same as a previous uptick or downtick. Thus it reflects the valuation decision of either a marginal buyer or a marginal seller. Over time, last price will reflect an aggregation of both marginal buys and marginal sells and thus can be considered a fair representation of market value over time.

Changes and Use of Estimates

As mentioned, it is commonly accepted that investors don’t like numbers to change, even when that change reflects increasing accuracy. So, when should numbers become “final?” In exploring this question, it is useful to consider the types of changes that can happen:

- *A report believed to be accurate is later revised.* Examples might include:
 - Broker issues such as trade corrections, incorrect prices, etc.
 - Final reports from underlying managers in a fund of funds that are changed.
 - A PIPE registration deadline is extended.
- *A number known to be an estimate is later finalized.* Examples might include:
 - Accruals for estimated tax and audit preparation costs.
 - Estimates from underlying managers in a fund-of-funds that are finalized.
- *A calculation believed to be correct is later discovered to be an error.* Examples might include:
 - A complex valuation worksheet is discovered to have improper comparative data or follows a pricing policy for a different category of security.
 - Final reports from underlying managers in a fund-of-funds that are changed.

Changes and Use of Estimates continued

- A report is received that was earlier presumed to have zero impact. Examples might include:
 - A fund-of-funds manager is late in reporting; to accelerate reports, in the absence of information, the return is assumed to be zero.
 - A bill for legal services is expected, but the amount is unknown.

Note that the first 3 types have the four basic qualitative ingredients discussed above. They can be (1) based on reason; (2) unbiased; (3) believed to be reasonably accurate at the time; and (4) consistent. The last type of change might be consistent (a fund-of-funds underlying manager is always valued at zero if reported late) and unbiased, but it is not apparent that it is based on reason or reasonably accurate.

The second ingredient in this discussion is *materiality*. As noted above, the NAV of a fund is only an estimate of liquidation value and would differ from actual liquidation proceeds, had it actually occurred. If the possible variance in a highly liquid fund might be plus or minus one-quarter or one-half percent, then a reasonable materiality threshold is likely in that range. Certainly, for most funds a materiality threshold of one-tenth of one percent (0.1%) would be an appropriate "safe harbor" level.

If the current period valuation is based on reports and work that have the four basic ingredients mentioned earlier, and the difference is within a 0.1% materiality threshold, APM would suggest that a fund consider adopting a policy where subsequent changes need not be carried back to the original period. On a case by case basis, changes that exceed the safe harbor may be approved.

Exceptions to the safe harbor adjustment concept would be changes or errors involving just one fund participant. In general, an adjustment pertaining to only one participant would have a materiality test relating to the participant. A change that would affect that participant by much more than 0.1% should carry back to the original period.

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