

Back to Basics: Portfolio Accounting 101 Transcript

“Back to Basics: Portfolio Accounting 101” was a live webinar on May 19, 2010. Jim Powell, CPA gave an introductory course on Portfolio Accounting that culminated in a question and answer session.

Portfolio Accounting 101 Webinar Transcript

Moderator:

Welcome to Back to Basics: Portfolio Accounting 101. I want to welcome you to our webinar today. I'll be taking you through our agenda... and today we'll be covering Introduction, talking about portfolios, accounting, Recording securities and activities, Updating Fair Market Value and cost/tax basis, discuss some transactions, review some broker statement anomalies, talk a little bit about financial reporting and Form 1099 reporting.

Our objective for today is to provide you with education couple that with experience and insight to help you tackle the day-to-day challenges of working with and for high net worth individuals.

We are very fortunate today to have with us Jim Powell, CPA, CFE – Retired. Jim has been in the accounting industry for over and over 40 years and has seen a lot during his time. With that I want to go ahead and turn this over to Jim...

Jim:

I'm here.

Moderator:

Great. And Jim now has controls and will be taking over from here. Thank you.

Jim:

Good morning or Good afternoon everyone. We want to talk a little bit today about Portfolio Accounting and this is the definition that we use for Portfolio Accounting that will drive the rest of this presentation.

"To provide accurate, meaningful and timely information for effective and efficient investment decision-making, financial reporting and management."

We feel if you keep this purpose in mind then the rest of the portfolio accounting concepts will follow.

We say that doing the portfolio accounting for high net worth individuals typically involves three steps:

The tracking of assets at both cost/tax basis and FMW, liabilities and equity. Tracking which is very important for many of our investors and principals, unrealized gains or losses for investments and the various income and expense accounts.

We typically rate portfolio investment down into, into two general types; one is Marketable Securities which is the thrust of our presentation today. The second being alternative investment which includes private equity, publicly traded partnerships and hedge funds. That will be the topic for our second webinar and

then we will also be presenting a third webinar on actually how to do some of the accountings for the various types of investments.

The first step that we feel is one of the most important steps in tracking investments is to determine how you want to identify the various security positions and organize them for reporting purposes. We typically refer to this as establishing the chart of accounts. Your positions can be organized in various ways for example, by holder which could be a broker, by the type of security for example, common stock who owns them for example, a trust and the purpose of the investment. In this case we are talking about long term growth but it's very important to make sure when you are setting up your securities the first time that you determine upfront on how you want them organized in the chart of accounts.

From there we can go into the basic steps into accounting for the marketable securities. The first thing we want to do is set up our existing portfolio and we define typically three ways that you can do this, the first is Lot by lot or block by block for example, if you own 10 individual lots of Apple then, you want to set up 10 different blocks in the chart of accounts. The second method is by security so you would take those 10 individual lots of common stocks and set them up in total in one account. Of course when you use this method it makes it a little more difficult to track purchase dates and short and long term capital gains. The last method is to record them in total by broker account and to rely on the individual broker statements for the details.

The second step in accounting for marketable securities is to record the purchase of new securities, we then would update our portfolio to the current market prices. We would record the sale of marketable securities (I apologize for the internet going so slow)

And then we would record some special types of security transactions and we'll talk about these a little bit more in a few minutes.

Next we want to record the activity in the account, again depending on how you set up your portfolio you can record Lot by lot or block by block and again depending whether you're you can either do this manually or in an automated mode by downloading from broker sites. The process, by security is by definition going to be manual because you're putting just as much when recording and total and the same thing by when you record by broker account.

No matter which method of recording activity you pick, we believe there are four key steps to be completed in posting the monthly broker accounts. First, you need to enter the cash activity as shown on the monthly broker statement, you need to Reconcile the broker cash account, need to Update the cost/tax basis of the portfolio and whether you are doing it manually or automated this should happen automatically and your software when you record purchases for sale and lastly you need to update the prices to update **FMV. If you got lot by lot or by security accounting or if you're doing it in total you simply post the**

change in the FMV between the beginning of the month and at the end of the month.

Most brokers do provide a summary analysis of the cash account for the month. Typically it will show the beginning balance, the condensed monthly activity and the ending balance. Typical items that you might have to post are listed below, all of these are cash items that typically flow through the cash accounts except for the bond amortization and accretion which some brokers are now starting to show on the monthly statements but for the most parts they are not shown on the monthly statement and have to be calculated.

Moderator:

Jim really quick before we move on to the next slide I want to make sure that everyone can still see the screen OK I'm just making sure that the internet is catching up. Often times the audience view is a little bit lagged ok, and if you don't mind I'm just going to launch quickly a poll for attendees and just asking a quick question.

Is anyone, everyone here is using an integrated GL and portfolio management system?

Try and get a sense of where our audience is coming from and the poll is coming in and it says 41% and things are trickling through. So let's just wait a couple more minutes and we'll slow this down just a little bit. Ok and so far so good, ok.

Close that up and I'm going to give you control...

And I also want to mention that I want to thank everyone in attendance. We had people signing up from as far away as Saudi Arabia, Australia, India, The Netherlands, Germany, our beloved state of California and all across the country from New York, Connecticut, Canada as well and as far as south as Mexico. So this seems to be a very important topic to a lot of people and near and dear to everyone's heart so I'm grateful for all the people attending from all over the world. I didn't think that this would be that popular but it's nice to know we're hitting an important issue that's close to everyone's heart. Ok Jim I'll go ahead and give it back to you.

Jim:

Ok, one of the other key steps each month in tracking your activities is to make sure we reconcile broker cash accounts and you reconcile a broker cash account just like any other checking or money market account that you have. The one typical difference is that unless there are some in transit items at the end of the month, typically your balance per book, the balance per book the statement will be the same so if you post it to the account, the cash account correctly difference between the two accounts and the reconciling amounts should be zero. In some cases we find that the difference depending on the how the broker record it, will

be the unsettled sales or purchases which of course automatically corrects the same the next month we recommend that all security transaction be recorded on them on a transaction date so you can have a number of transaction ready end of the month. Some times there will be in transit items. If there are other differences then you need to get into the detail statement to see if you can determine the missing items the the key being that broker cash account should be able to reconcile at the end of the month just like any other bank account.

The next thing we want to do once we've posted everything through the bank account is that we want to update our account balance with the fair market value. For Lot by lot accounting you typically would download manually under the prices, you would record the prices into the system, you would update the account balance for FMV and you would show on your balance sheet the FMV as of the month end or whatever evaluation date you have on it.

The unrealized gain/loss should be updated automatically through the journal for the change in the prices.

In summary accounting, you do pretty much the same thing except that you do it on an overall basis so the first thing you want to do is post an overall update of the cost basis for the portfolio. You want to enter the current month end date as the valuation date and cost and tax basis for the total security of portfolio shown on the broker statement and you want to post the change in the FMV. Again you're doing this at a summary level. You want to, the other thing that has to be done manually is you calculate the difference between the FMV shown on the monthly broker statement and the amount shown after all the above steps are complete and this difference becomes a change in the FMV for the month.

Other types of transactions that show up on the broker statements that sometimes requires a significant amount of manual intervention are listed below. All of these are typically cash basis transactions except for the bond amortization or accretion. A lot of times you'll have to dig into the details to determine exactly how the transaction should be recorded and sometimes you'll even need to go to the company websites to find out for example, how to record a stock merger.

Moderator:

Jim before we go back to the next item, can you move one slide back really quick could you just tell us little bit about some of these transactions that we see on the statement for example, a partial security sale. Is it common for the broker statement to actually be part of security sale or sort of just break up **the lots and** assume that you're going to know that's a partial sale?

Jim:

Well, typically on most broker statements what you'll see is, say you got a block of 100 securities and you got an account that's on program trading until they sell. They sell 7 shares out of that block. You should be able to tell from the broker

statement what block the stock came out of and what was the purchase date all the information that you would record that you sold the entire block except in this case you are only recording sale for only 7 % of the security. Typically you would expect that any software that you would be using would automatically calculate the proper cost basis for the partial sale.

Stock splits and Reverse stock splits are typically shown on the monthly statements. But you have to look for them because there is usually no cash basis in there. Spin-offs create a problem for some brokers because they don't get the cost basis correct. Dividend reinvestment is just like a regular dividend coming in and then you turn around and repurchase the shares. Cash in lieu when you got a fractional share on a split or a merger and you get cash in lieu of them in place of the fractional share again a lot of times brokers have trouble with this kind of things calculating the cost basis. Stock merger is one word that you may very well wind up having to go to the merge company site to get details of the merger so you can record it.

Moderator:

But Jim, on the stock merger transaction is there a usually a line item on the statement that mentions that there is a merger between these two companies. Do you have to usually do your own digging to find that out or do they notify you on the statement?

Jim:

Typically there's a notification for example, when Berkshire Hathaway bought Burlington Sante Fe railroad, there was an indication on the statement of what happened that's explained exactly you know they had merged and what they had what the share were and new shares between old shares there wasn't a detail recalculation of the cost basis of the old share and the new shares at least the particular broker that I was working at so usually the information is there but sometimes you have to go to the website of the merge company in order to get all the details.

Moderator:

Ok, and Bond amortization or accretion...

Jim:

That's probably with most broker statements one of the biggest problems very few of the brokers will show you the details of the bonding amortization or accretion. All that typically happens is that the cost basis of a bond at the end of March might be a 100,000 dollars and at the end of April it changes to 99,500 dollars and you have to go through and manually compare the two cost basis to see that the amortization on that bond for the month is 500 dollars. Some of the brokers have started actually showing the bond amortization or accretion

on their monthly statements. Other's if you have a real problem with calculating the amortization they have the information available in separate reports but they typically don't provide to their clients and you can many time just request your principal or your clients to obtain those reports from the brokers.

Moderator:

And is that a process that someone should enter the journal entry every single month. When is the right time to amortize the bond?

Jim:

Well, Obviously you have to record the amortization for certain just before you sell it but I usually recommend my clients as often as you price the portfolio you need to record the amortization because obviously you don't get the unrealized /loss correct gain if you don't calculate the amortization the unrealized loss and gains going to be correct. If you price monthly I record amortization monthly, if you price quarterly I record quarterly. Obviously at minimum you want to price it at the end of the year and adjust the FMV and accretion gain accordingly.

Moderator:

And the other last few transactions here Transfer of assets from one entity to another and gifts notify statement that are easy to pick up.

Jim:

It is easy to pick up that the assets were transferred many times what happens is that brokerage account will transfer assets at the FMV on the date of transfer rather than transferring the cost basis so sometimes you got to make sure when you go from one entity to another the broker statement is properly picked up the cost basis. Again on non-cash contributions and gifts, a lot of time they'll just show the share being released from the portfolio and the cost basis will be adjusted in the detail but you'll have to calculate it manually. Again the thing I want to stress here is that every broker handles these types of things in their statements differently and that the key here is to make sure you really understand your particular broker or brokers do in putting these types of transaction.

Moderator:

Ok, thank you that's good.

Jim:

It's time to move into the next slide and I've already eluded doing number but one of things that we found over the years that depending on the broker there are all sorts of anomalies that can creep into the statements that have absolutely nothing to do with the ability of any kind of software to process them or **people**

to process them manually. This is some of the broker statements actually crack the information as they have all these anomalies in them. And this is going to become even more important now that IRS is going to require the brokers to submit the detail capital gain or loss information in addition to the proceeds that have been required in the prior years. I see a lot of statements where the cost basis is not properly stated, the short and long term capital gains are recalculated etc.

Another thing is, in financial reporting whatever system you are using all information you just posted from the broker statement should go directly into your financial report. This will give you the combined reporting for all broker accounts by entity and we feel that at the minimum you ought to be able to get from your system the information listed below. Most systems will provide you with the balance sheet income statement and cash flow but the other schedule for proper management, proper planning and proper investment and also for preparation of tax returns are really necessary in order for the accounts to be properly managed.

The other thing we want to touch on today is the form 1099 reporting because this causes a lot of people headache, what will happen if the brokers will furnish the final statement for the end of the year. You download the information and get all the details. You get the 1099 report; it doesn't look too much like what you downloaded in December. We tell the two major issues with 1099 reporting. One, is the transactions are not downloadable and must be posted manually. I have not seen and there may be, but I have not seen a broker that allows the direct download of the information from the 1099 and there may be any number of differences from the year end broker statements. I've listed, I've listed four of them here but basically some brokers are very good at reporting this information, others simply put an "asterisk" on it to say the amount is changed. It depends again on what your broker tells, but we feel it's important that information from the 1099 at least be posted in summary to the financial records and like I say what we see is that this requires a significant amount of manual intervention.

We, in summary feel that you do need an integrated financial and management reporting system and without one, it may be difficult to maintain a combined set of books for an entity, either on a cost or FMV, provide meaningful financial reports without cutting and pasting information from multiple applications, Reconcile the year-end statements to the annual tax report and prepare the various intangible, state and federal tax returns.

This concludes my portion of the presentation. I greatly thank everyone for participating and you know I think we've a little bit of time left to take a few questions.

Moderator:

We do and so to be able to touch the questions in the GoToWebinar box and submit them to me and I'll hand them to Jim so he can answer them for you. Jim we've got some questions right now coming through. Here's one of them:

Are there times when the brokers don't provide some of the transactions on a statement at all and you have to figure out what's missing?

Jim:

Yes, there are a number of situations where some brokers simply do not provide the information in as part of the cash analysis and you need to go in and dig. For example, one thing that I just had happened recently on a broker statement is that between the March statement and the April statement, the broker adjusted the cost basis of certain security and there was absolutely no indication anywhere on the report, that the cost basis had been adjusted ... And we found the differences simply by analyzing, by looking item by item and comparing them the broker statement to the cost basis that we had recorded at the end of the month. And of course, the other one I mentioned earlier is one of the biggest problems for people is the bond amortization/accretion which by and large is not posted. So sometimes it does take a significant amount of digging to figure out what the brokers have done.

Moderator:

Must be very frustrating on your end, to actually have to deal with all of that... ok.

And, unfortunately time consuming...

Another question that comes in: Is the reconciliation of the end of year statement to the 1099 still a tedious process?

Jim:

Depending on the broker it can be relatively straight forward or it can be tedious depending on the trail that they actually provide on the 1099 statement. Some brokers are very good about telling you exactly what the differences are between the December statement and what's on the 1099 and other's like I said earlier Simply have an asterisk to show you change in amounts or simply report the amounts but no trail of how they got to the statement from the year end statement to the 1099 statement and like I mention the ... The one major issue here is you do it's all of that posting to the financial records is manual but typically you do want to get that 1099 to tie into your statement. So you've got a significant amount of manual intervention.

Moderator:

Okay, that's great, thank you.

Questions just came up and I think you did answer this earlier. How should we handle amortization/accretion of bonds? What are some of the steps that we should take in order to properly account for fixed income instruments? Can you possibly review that again Jim?

Jim:

Well, the bond amortization/accretion must be recorded as a non cash item just prior to recording the sale, the final sale of a bond but I've always recommended that whenever, whatever period you use to price the portfolio, if you use monthly or quarterly or annually, you record the bond amortization/accretion in the same time frame. So if you're recording at the end of each quarter, you want to calculate the amortization at the end of each quarter and record it. That's the really the only way to ensure that your unrealized gain/loss is correct.

Moderator:

Ok, great. We had some other questions... Jim, how do you determine fair market value and can you talk a little bit about where someone can actually get pricing for that, pricing information if it's not readily available.

Jim:

Well, usually your pricing information is going to be shown on monthly broker statements. A lot of times the brokers do not provide the monthly pricing for alternative investments which is the subject of the next seminar but that they will have that information available upon request but there's a ..You know there are other sources that you can use if you are using automated software where you can download the pricing and not post it manually. Manual posting usually requires you to simply pull it off the broker statement while using downloadable pricing you can automatically post it update the portfolios.

Moderator:

Ok, that's great.

I've got a whole bunch of questions here. Jim, do you have any suggestions on how to handle Wash sales for tax purposes, it says here portfolio management system has more limitations in this area and I've found many times the broker statements are wrong and when I question them they have to be corrected. Can you address it to the wash sale is there something that you can talk a little bit about?

Jim:

Well, again most of the software that I'm familiar with will, will handle the wash

sale properly simply through the basic recording process. And I run into the same thing where quite candidly the brokers get it wrong and that you know the individual client or investors get it correct, I mean I (excuse me) I don't know any way to handle this other than making sure that when we enter it into the software. This is true with any kind of usual transaction that we get it correct and the broker get it wrong, we ask them to fix it. And again we are going to get to a situation where brokers are now reporting capital gain or loss information to the IRS so we want to certainly make sure that from our standpoint whatever the reporting is correct. Otherwise, we're going to have a lot of reconciling items between them, between what we post to the IRS and what has been reported in the IRS.

Moderator:

Ok, thank you.

This question here, Can you please comment on tips accounting specifically basis adjustment showing only on 1099 with no explanation?

Jim:

I haven't dealt with tips in a long time other than I do know that certain types of industries have to gross up tips on the 1099 by (excuse me) a certain fixed percentage but without seeing I mean what I would suggest here is if the person wants to email you the information, we can certainly take a look at and get them an answer but I have haven't worked on tip for a long time.

Moderator:

Ok, another question is: What is your recommendation for handling the sale of an investment and after that sale is recorded the cost basis change to something like partnership, Distribution etc.?

Jim:

My recommendation (excuse me) has always been to go back and fix it on the date it happened as if you knew about it at the time. I mean this is the same thing we get what you know... day one is coming in, in the first part of September that applied to the previous year end I have always recommended that you go back and fix it on an as is basis and you know most software should be able to handle that and automatically roll forward the updated information without any additional manual intervention.

Moderator:

Ok, well a lot of questions about the actual presentation so just so everyone knows. We will be emailing out to you tomorrow PDF copies of all these slides. And within 1-3 weeks we will have the recorded webinar available to watch and listen on our website and you will be receiving an email update of that as well.

So, thanks for all those questions and we'll be putting all that out very soon.

Moderator:

Here is another question: How do you handle broker that provided a cost basis for the sale of securities but do not provide lot details?

Jim:

My reaction would be that that you need to request that information from the broker because the chances are that they've got another statement that they are not providing to you that has that detail. I have not run into one yet that I haven't been able to get detail once I asked for, if, if they really don't have the detail and I do have one that I ran into that it's very difficult to get the detail from, I simply wind up preparing spreadsheets assuming fiver just break down the total proceeds into the blocks. I've got them recorded on the... on my financial software. So, if I've got, you know, a total number of 200 shares and it's in blocks of 50-40-40-50-and 20, I will break down the sales proceeds based on those relative percentages and then simply record it on a trifle basis. Nothing that's the answer by the way for everybody. But that's how I do it.

Moderator:

Ok. Jim one question here is: Are any broker statements better than others and can you name names?

Jim:

The simple answer to that is 'yes' and I prefer as you and I discussed before I prefer not to name names on broker statements on a public webinar.

Moderator:

Ok, here is another question: If your only bonds are miniscule, do you really need to record amortization/and accretion, if you are buying and holding bonds to maturity?

Jim:

Again you don't need to but if you want your unrealized gain/loss on your portfolio to be correct then it would make sense to at least record them once a year for proper reporting but know if you're buying munies and you're holding them to all the way to maturity as long as you record the total amortization you know the day before you sell it then, no, you don't have to record it. Again it's it's a management reporting and procedure to let people know what the unrealized gain/loss might be on the bond.

Moderator:

Ok, that's good. Another question is: Do you recommend keeping a separate account for sweep cash as compared to upswept cash?

Jim:

I don't do it. When I do broker statements I just keep total cash because the theory is, the theory is that at any point of time the sweep cash ought to be zero but I realize that in some cases people want to keep two accounts but it just makes the accounting more complicated. The only place that I keep that when I have trust and I have principal cash and income cash. I will keep two accounts each at the end of each month to account for that cash.

Moderator:

Ok the other question is: Do you set up separate tax slots for dividend reinvestment or average cost?

Jim:

Personally, I set up separate tax slot but again this goes back to how does the broker do it. Does the broker set up all those 1.31 shares as in total and just keep track of short and long terms or do they in fact set up separate blocks. In their detail records they're going to have the separate blocks but again this all depends on how you want to account for and remember at some point you got to have the information to prepare your tax return.

Moderator:

Ok that's good. Are brokers open to changing the downloads of missing items or incorrect items that happen time after time?

Jim:

I think this is a question you probably want to ask your technical people that work with the brokers all the time. I know there was one broker, one very large broker that I worked on a test force that was about 4 years ago to get the download information to change and they change the significant amount of it and completely reformat it their statement based on the recommendations of the test force probably we got all done we still had a very very significant number of anomalies in their monthly statements. Really, it'll depend to some extent on how big the customers and how much pressure they can put on the broker.

Moderator:

Another question is: How important do you feel consistency in pricing is when considering FMV, particularly for bonds, different brokers may be using different and conflicting sources.

Jim:

I, tentatively, I have not run into that my, my recommendation would be is, if that's the case you might want to consider that using one of the online pricing services and simply price your portfolio consistently across all your broker accounts and entities using the pricing service, again you would hope that if there are differences at the end of the month between broker statements that its pennies that are insignificant and I would recommend just using one price for all of like bonds.

Moderator:

Ok, another question is: Do bank custodians do a better job of reporting as compared to broker custodians?

Jim:

In most cases today your bank custodians and your broker custodians are kind of very intertwine. I can't really comment on which one does a better job but for example, I mean take Wells Fargo which is Wells Fargo security is an example which acquired vacuous securities which acquired A. G. Edwards. So now you got a huge bank that is also doing all of your broker accounting but I can't really comment which one which one does a better job and like I said all of the statements have, have some anomalies.

Moderator:

Ok, that's great.

We are running out of time here and there are some others questions that we didn't have a chance to answer. And I will do my very best to respond to those in the next day or so. I want to take time to take everyone to one more slide and mention that recording of this seminar will be available on our Resource Center, probably in about 1-3 weeks. And the link is listed there on the screen. We should have downloadable slides to everybody as well as the evaluation form for CPE credits available to you by tomorrow. And, also mark your calendars we are going to have another upcoming webinar and this is going to be titled "Portfolio Accounting 201" and we'll be talking about Alternative Investments and that will be in July. The date has not been set but we'll be sending out an email to everyone in the next month or so with that date.

And some basic instructions here for the CPE credits, while for the CPAs that are here in attendance, please download the evaluation form and email it back to: marketing@finnav.com, with the subject heading, "CPE Credit: Portfolio Accounting 101." Please allow 4-6 weeks for the certificate to be emailed back to you.

And one other slide just quickly on who we are:

Financial Navigator is a solution for family offices, CPA firms, foundations, and trust and estate firms. It is used by CPAs, CFOs, Controllers, Accountants, integrated GL, portfolio management and reporting tool. And we've been basically in business since 1983.

Ok, that's pretty much all the time we have, again these slides will be sent out to everyone tomorrow and you'll be able to download them in PDF format. I want to thank you Jim for taking the time to educate us on some of the things that we should be aware of when it comes to portfolio accounting. Your insight and experience has been very helpful. And everyone thank you for attending our today's webinar and we look forward to seeing you online in July for part two, "Portfolio Accounting for Alternative Investments." Thank you Jim.

Jim:

Thanks, Moderator and thanks to all the participants.

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