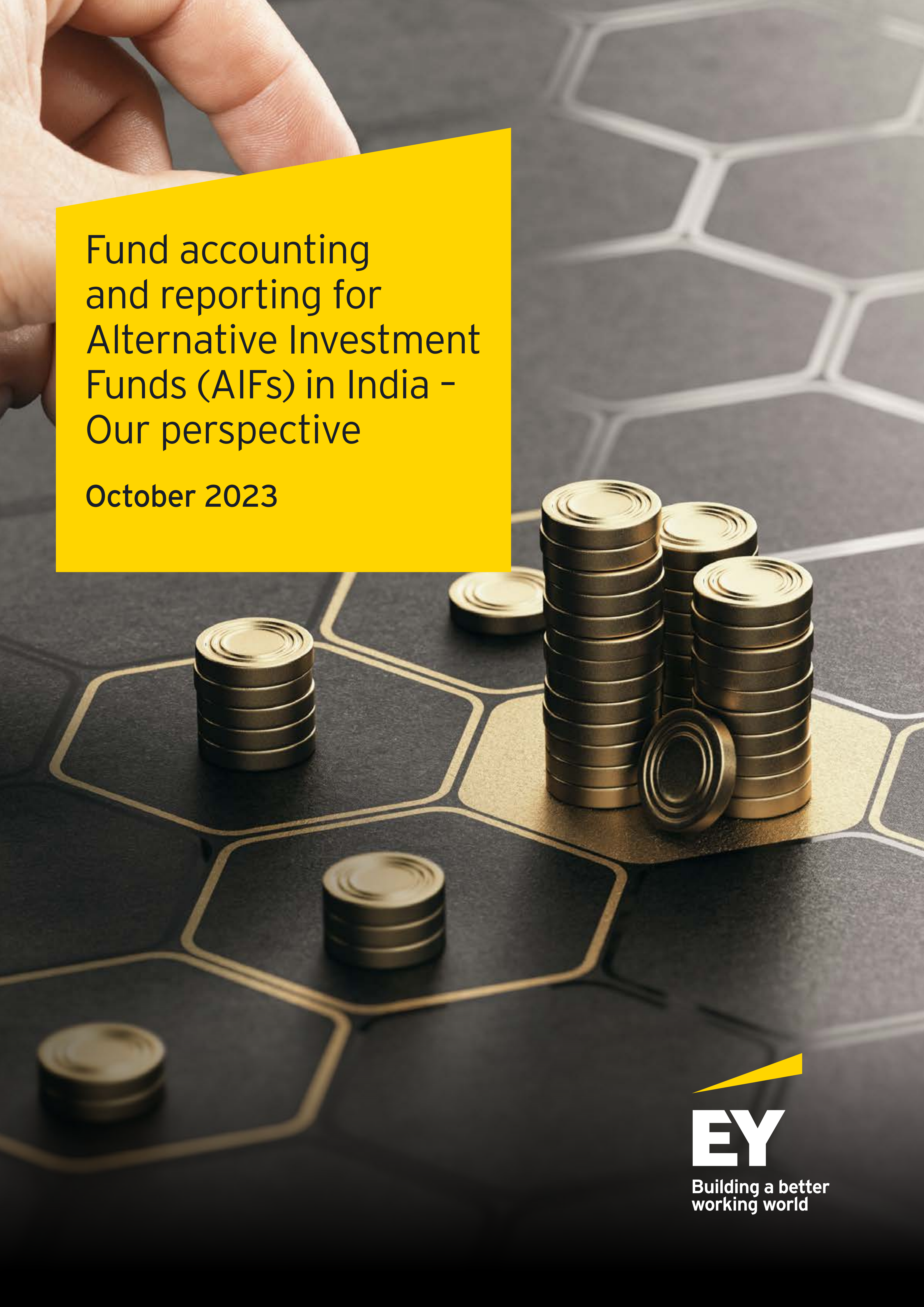

Fund accounting and reporting for Alternative Investment Funds (AIFs) in India - Our perspective

October 2023

Building a better working world

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Background

Alternative investment funds (AIFs) have gained immense popularity in India, as they provide investors with a varied choice of alternative assets such as private equity, real estate, and infrastructure. These assets offer diversification beyond conventional investment options, such as equities, bonds, currencies, or gold.

Despite market volatility caused by global challenges such as the Russia-Ukraine War, pandemic, oil crisis, and so on, AIFs in India have shown resilience and piqued the interest of investors with features such as the potential for high returns, diversification, unique investment opportunities, and customization options.

AIFs play an important role in providing capital to start-up and early-stage companies that have helped fuel the growth of the Indian start-up ecosystem. AIFs, as a critical component of the financial system, have evolved over time, influencing technological improvements, economic cycles, and regulatory changes.

Government initiatives and reforms, such as the establishment of Gujarat International Finance Tec-City (GIFT City), is igniting the next phase of expansion for Alternative Investment Funds (AIFs) that operate in India.

Tax incentives, exemptions from FEMA regulations, access to foreign investors and markets, and state-of-the-art infrastructure and technology are some of the advantages of operating out of GIFT City. GIFT City offers a good platform for India-focused offshore feeder funds that are set-up outside India.

Securities and Exchange Board of India (SEBI) has introduced various measures, such as the introduction of new types of AIFs, investor protection measures, innovation promotion, investor education initiatives etc, to foster investor confidence, transparency and to promote overall AIFs market in India.

Institutional investors like pension funds, endowments, sovereign wealth funds, insurance companies, and others are becoming more interested in India's alternative investment market due to the potential for higher returns and benefits of diversification offered by alternative assets.

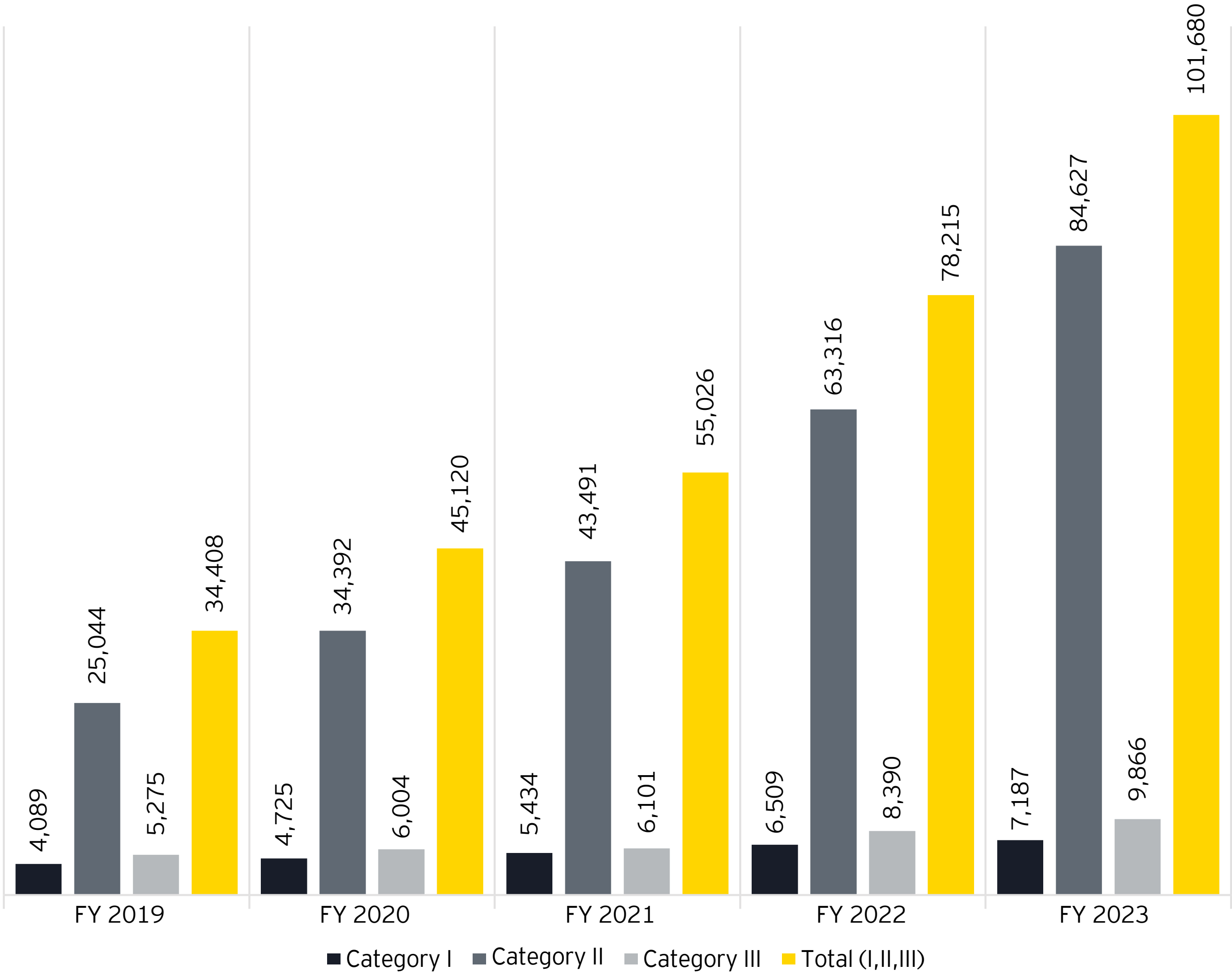
ESG factors have now become more relevant and important as institutional investors look for investments that align with their values and beliefs while also generating financial returns and having positive social and environmental effects. Good ESG practises will assist in achieving long-term value when stakeholders incorporate ESG factors into their investment decision-making.

Due to this tremendous growth, driven by good government initiatives, reforms by SEBI and growing interest from investors, the back-office functions covering end-to-end fund accounting, operations and investor reporting are becoming complex, particularly for funds with outdated technology, multiple systems, manual processes, and competency issues, forcing them to reconsider their current operating model.

This document highlights the market outlook, key challenges faced by AIFs in the end-to-end record to reporting, including fund accounting and reporting and includes our perspectives on how to address them.

02 Market landscape

AUM in US$m



SEBI | Data relating to activities of Alternative Investment Funds (AIFs) (Link for the above data)

Note: The above report is compiled on the basis of quarterly / monthly information submitted to SEBI by registered Alternative Investment Funds. Exchange rate @US$82 was used for conversion

Cumulative net figures as at the end of 31 March 2023

In US$m

Category of AIFs	Commitments raised	Funds raised	Investments made
Category I			
Infrastructure Fund	1,900	667	578
Social Venture Fund	180	69	40
Venture Capital Fund	5,089	2,706	2,303
SME Fund	18	8	6
Category I Total	7,187	3,449	2,928
Category II	84,627	32,475	29,624
Category III	9,866	8,662	8,665
Grand Total	**101,680**	**44,586**	**41,217**

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Due to the growing popularity of AIFs amongst both domestic and international investors, India's AIFs industry has experienced tremendous growth. Over the past five years, total AUM (also known as commitments raised in AIFs parlance) has increased close to 3 times, from US$34b in FY 2019 to US$101b in FY 2023.

The AIFs industry expanded by a staggering 30% in FY 2023 to reach an AUM of US$101b from US$78b in FY 2022.

Category II of AIFs is the dominant category of AIFs in India. At the end of March 2023, commitments totaling US$84b were primarily made with Category II funds. When compared to the March 2022 value of US$63b, the amount is 33.66% more.

Category II AIFs consist of several types of funds, such as real estate funds, private equity funds (PE funds), funds for distressed assets, etc.

03 Key challenges

1 Manual processes

- While AIFs tend to rely on customized third-party accounting software to manage their books of accounts, a good number of AIFs are still relying on manual fund accounting processes in spite of complex and large volume of transactions.

  Manual fund accounting poses the following challenges for AIFs:
  - Prone to errors
  - Lack of security
  - Time consuming
  - Limited scalability
  - Limited reporting capabilities
- For instance, fund administrators of some of the AIFs may manually:
  - Compute NAV of the fund
  - Perform equalization adjustment
  - Execute capital calls
  - Perform reconciliation of positions and cash
  - Distribute cash flows to investors
  - Compute ratios such as IRR, TVPI, DVPI, etc
  - Perform MIS reporting.

  Even worse, these procedures frequently entail switching between various teams and data sources that can lead to inefficiencies and bottlenecks.
- Other instances include using manual loader to insert journals – where data points such as ledger and sub code, trade dates, amount, trade price, are inputted manually that significantly increase the risk of errors and create issues in the reconciliation process.

  Where inaccuracies are discovered by investors, they lose faith in all the information supplied by the fund manager.

Our perspective

- While manual end to end fund accounting is generally a more affordable alternative for some of the AIFs with lower transaction volumes, it comes with several drawbacks that severely restrict the organization's ability to scale, increase reputational risk, and make the fund more prone to errors.
- Considering the challenges in the manual accounting, it has become imperative for the fund managers to consider the use of technology in managing their books of accounts with a robust outsourcing arrangement.

2 Diverse accounting requirements

- AIFs are required to abide by several regulations, including Generally Accepted Accounting Principles (GAAP) covering Indian GAAP. Specialized knowledge and experience is needed for compliance with accounting standards that could be difficult and time consuming in complex situations, for e.g., consolidation of funds.
- Investors also require financial statements, performance reports and tax data frequently. The accuracy and timeliness of the data that investors rely on comes from a variety of different sources, including trading platforms, custodians, and market data providers. Where such external sourcing and reconciliation of data is not managed robustly, it may increase the risk of errors or omissions and invariably result in delays in closing the books and finalize NAV.

  Given the existence of manual disparate systems for record-keeping and reporting, there are gaps in the integration of data across several subsystems that complicate operations and raise the possibility of inaccurate or delayed fund financial reporting.
- Where any relevant reference data is changed in one source system, it must be cross-referenced and replicated in all the working files where it is not linked.

  For instance, any change in the name of the investor post on-boarding must also be updated in the fund accounting and reporting system
- The manual preparation of financial statements and investor reporting may result in inadvertent errors.

  For instance, corporate actions such as dividend payment by investee company not accounted for results in incorrect computation of funds' financial statements and investor reporting.
- In instances where both fund accounting and custody services are outsourced to the same vendor, any errors made in the custody processes may not necessarily be reflected in fund accounting and could be adjusted subsequently. For instance, not adjusting position reconciliation discrepancies in fund financials and NAV calculations.
- Similarly, delays and challenges are observed with respect to obtaining specific information from registrar and transfer agents (RTAs) such as processing subscriptions and redemptions or managing the transfer of units, etc.

Our perspective

- To enhance the effectiveness of back-office fund accounting and reporting, funds can consider using an independent service provider with strong domain experience on fund accounting along with a robust automated end to end fund reporting tool. Such an approach could enhance independence, objectivity, and governance over the integrity of fund reporting and inspire the required confidence amongst the investors of the fund.
- AIFs may also need to consider investing in adequate staff training on fund accounting and reporting, regulatory requirements and technical skills related to financial reporting under relevant GAAPs.

3 Failure to track regulatory changes

- The regulatory landscape for AIFs in India is complex and ever-changing, making it difficult to comply with all of them. AIFs are governed by the Securities and Exchange Board of India (SEBI), where rules and regulations are frequently updated, making it challenging for fund managers to stay updated.
- If the implementation of such circulars and regulations issued by SEBI is not done on timely manner, then the fund manager may face penalties from SEBI and in some extreme cases may even lead to closure of the fund and cancellation of AIFs license.

For instance: - SEBI has recently come up with circular SEBI/HO/AFD/PoD1/CIR/2023/96 dated 21 June 2023 on new requirement such as:

As per Regulation 10(aa) of AIF Regulations, AIF units shall be issued in dematerialized form.

Schemes of AIFs with corpus >= INR 500 crores, the dematerialization of all the units issued should be done latest by 31 October 2023, and any further issuance of units shall be only in dematerialised form from 1 November 2023 onwards.

Schemes of AIFs with corpus < INR 500 crores, dematerialization of all the units issued should be done latest by 30 April 2024, and any further issuance of units shall be only in dematerialized form from 01 May 2024 onwards.

The terms of transfer of units of AIF held by an investor in dematerialized form shall continue to be governed by the terms of private placement memorandum (‘PPM’), agreements entered between the AIF and the investors and any other fund documents.

Our perspective

- AIFs should look to automate and streamline their existing regulatory reporting process and should maintain a repository of all the circulars issued by SEBI, including notes, mails, and correspondences with the Regulators. The repository should have a summary of the requirements of the circular, key impact areas and effective date of implementation.
- AIFs should perform impact assessments to understand how new regulations will affect the operations of the fund and must take steps to identify what changes are required to be made to policies, procedures, systems, processes, and controls to comply with the regulations.
- AIFs should have dedicated team or personnel who are experienced in SEBI compliance and reporting and have strong domain knowledge of implementing regulatory requirement in the existing books and record system.
- AIFs should constantly update themselves with the latest regulatory developments by:
    - Monitoring regulatory websites periodically
    - Attending industry conferences and seminars
    - Subscribing to industry newsletters such as National Institute of Securities Market (NISM) publications and thought leaderships
- Issuance of units of AIFs in dematerialized form
    - Dematerialization would require AIFs to coordinate with various parties such as the registrar and transfer agent, the depository participant, investor, etc.

      AIFs would need to establish an interface with depository to facilitate any transfer of units, including transmission of instructions and information, as any operational challenge or delay can severely impact the investors' ability to buy or sell AIFs units.
    - AIFs would need to determine the cost of dematerialization, such as account opening charges, AMC charges, transaction charges, are kept to the minimum, as it can be deterrent for some investors.

04
Our point of view

A Governance

While efforts are being made by AIFs to strengthen its governance framework with a focus on transparency, accountability, and investor protection, additional steps are required to foster investor confidence.

1. Third-party vendors

KPIs should be clearly defined and documented for the work outsourced to third-party vendors and monitored on a regular basis to avoid any errors that may directly impact the AIFs reputation and investor confidence.

KPIs for end-to-end fund accounting and reporting may include:

- Accuracy of financial statements
- Timeliness of financial reporting
- Efficiency of end-to-end record to report processes
- Cost effectiveness and ability to scale up when more funds are on-boarded

AIFs should be aware about the platforms being used for fund accounting and reporting operations and should develop mechanism to independently review the work outsourced.

2. Standardizing fund accounting practices

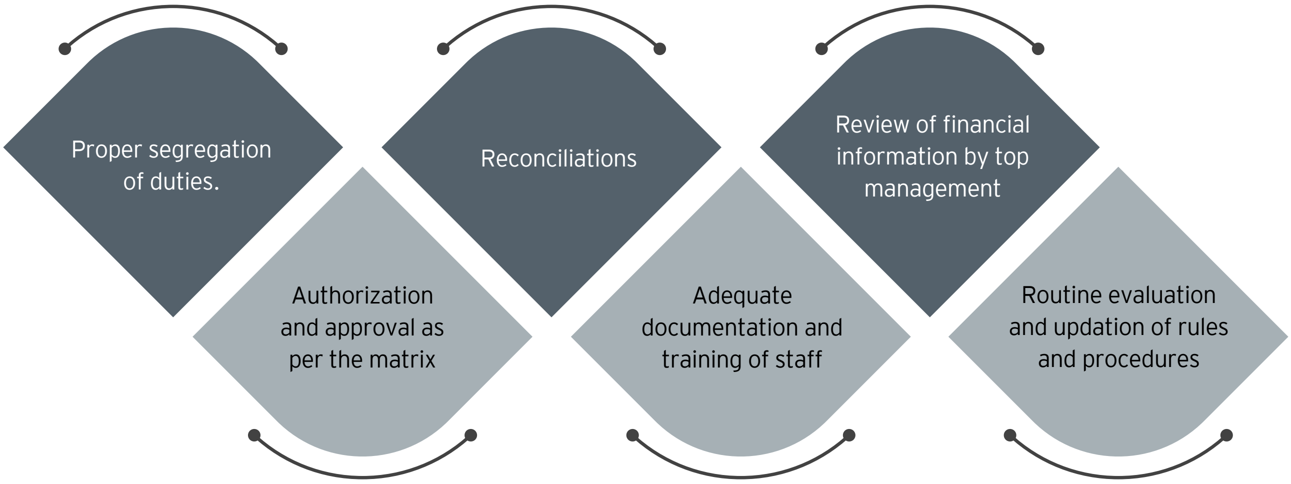
At present, most AIFs have different categories of funds and multiple schemes within such fund. There is more than one fund administrator for fund accounting operations for such schemes. Multiple vendors are also on account of location of funds in different jurisdiction because of which there is lack of standardized fund accounting practices.

While SEBI has not prescribed any specific accounting framework, standardizing can help to reduce the risk of errors, improve financial reporting, and facilitate compliance with regulations and best practices. AIFs could look to standardize fund accounting practices such as develop chart of accounts, adopt industry best practices, develop policies and procedures, provide training to staff on industry leading practices.

3. Enhance internal controls

A yardstick for implementation of robust internal controls framework for AIFs would revolve around control environment and control activities. It is imperative for AIFs to set the right tone and culture with respect to internal controls, as it can prevent frauds and errors and inspire confidence across investors and regulators. Internal control is an important component of governance framework that supports accuracy and completeness of financial information.

This would typically entail the following:



4. MIS reporting

Investors now are no longer seeking just the traditional information about the fund performance but are also seeking portfolio companies' information such as market demographics and penetration of the investee company, headcount of different business vertical wise, count of male and female employees of investee company, ESG score etc. AIFs would need to invest in appropriate solutions to capture and store such data.

B Technology

AIFs currently tend to use disparate platforms for client -onboarding (KYC and AML), fund accounting and reporting, SEBI compliance and reporting, investor reporting and bespoke MIS reporting, etc.

A best-case scenario would entail having a single unified platform with at least the following capabilities:

- KYC and AML screening tools for seamless onboarding of investors
- Fund accounting and reporting (including regulatory/ compliance reporting)
- MIS Reporting by leveraging data visualization tools like Power BI, Tableau, etc
- Investor Reporting – Real time access to investors on their fund performance reports.

Data is critical to the fund's operations since it is required for complete and accurate accounting, assessment of performance, regulatory compliance, and decision-making.

Such a unified platform can seamlessly manage various tasks such as KYC/AML, draw downs, commitments, capital calls, distributions, corporate actions processing, IRR, reconciliations, NAV computation on real time basis, financial and regulatory reporting, etc.

Where such platform has pre-loaded APIs (Application Program Interface) to take feeds from Bloomberg, Reuters, exchanges, banks (so long as the fund has subscribed to such portals), this would allow the fund manager and investors to access real time NAVs and fund performance assuming the fund has invested in listed securities. This would result in improved effectiveness and quicker processing times, thereby reducing the overall cost and improving the return on investment in due course.

By automating the reconciliation process and providing real-time updates on the status of transactions, it will help prevent errors, misstatements, and potential non-compliance with SEBI requirements. The technology used

in fund accounting should also provide an audit trail of transactions and should have a mechanism for maker checker review.

With the help of robust technological platform, that provides seamless access over the required books and records, AIFs can monitor and communicate more effectively with RTAs for various purposes such as processing units during drawdowns, redemptions, transfer of units.

Similarly, being equipped with such a robust unified platform would enable both the AIFs and its independent fund administrator to monitor and govern various operational aspects of the custodians, such as treatment of reconciliation breaks, shortfalls.

C Upskilling of resources

- With the increasing complexity of financial products and services, there is a growing demand for professionals with specialized skills in areas such as hedge fund accounting, private equity accounting, and real estate accounting.
- The need for upskilling of resources in fund accounting, reporting and operations is becoming increasingly important due to the evolving nature of the industry and the increasing demand for specialized skills in this field.
- Fund administrators use various platforms to provide end to end fund accounting and reporting support for category I, II and III AIFs. As a result, it becomes critical to have the relevant professionals in private equity, hedge funds and real estate accounting with experience of working on such platforms to minimize the impact of errors.

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