

## Understanding Financial Highlights in the Financial Statements of Hedge Funds

By Ross  
Ellberg, CPA,  
Arthur Bell  
Certified  
Public  
Accountants

### Background

Since 2003, nonregistered investment partnerships (hedge funds) have been required by accounting principles generally accepted in the United States (U.S. GAAP or GAAP) to present financial highlights in their financial statements. Prior to 2003, there was not a requirement for hedge funds to present financial highlights in their financial statements. In contrast, registered investment companies (mutual funds) have historically had a requirement to present financial highlights in their financial statements in order to be in compliance with GAAP. The primary objective of financial highlights is to provide the financial statement user with: (i) objective data regarding the results of the hedge fund's operations and significant financial statement ratios, and (ii) a measure by which to compare such financial data among hedge funds (the "comparability" objective). As with all data or statistics, financial or otherwise, caution must be used when drawing conclusions or making decisions based on the data presented. Among other factors, the user of such data must understand how the data was derived, the statistical validity of the data and any data bias that may exist. Such is also the case with financial highlights of hedge funds. The goal of this article is provide a basic understanding of: (i) the presentation and disclosure requirements of financial highlights; (ii) how financial highlights are calculated; and (iii) the benefits and limitations of financial highlights in the financial statements of hedge funds. As the focus of this article is financial highlights of hedge funds, financial highlights of private equity funds are excluded from this article's scope.

### Presentation and Disclosure Requirements

The presentation and disclosure requirements presented herein are general in nature. The specific presentation and disclosure requirements are contained in American Institute of Certified Public Accountants (AICPA) Statement of Position 95-2, *Reporting Financial*

*Highlights and Schedule of Investments by Nonregistered Investment Partnerships: An Amendment to the Audit and Accounting Guide Audits of Investment Companies and AICPA Statement of Position 95-2, Financial Reporting by Nonpublic Investment Partnerships, as codified in the AICPA Audit and Accounting Guide: Investment Companies* (May 1, 2007 edition).

The presentation and disclosure requirements vary depending on if the hedge fund is a: (i) capital based fund; (ii) a unit or share based fund; or (iii) a private equity fund. The general disclosure requirements for capital based funds and unit or share based funds are as follows:

#### Capital Based Funds

- Total return, both before and after the incentive allocation or fee for each reporting class taken as a whole (Total Return);
- Ratio of expenses, both before and after the incentive allocation or fee, to average net assets for each reporting class taken as a whole (Expense Ratio);
- Ratio of net investment income (excluding the incentive allocation or fee) to average net assets for each reporting class taken as a whole (Net Investment Income Ratio); and
- Other disclosure information.

#### Unit or Share Based Funds

- Per unit or share information, which details the change in net asset value per unit or share at the beginning of the period to net asset value per unit or share at the end of the period, for each reporting class taken as a whole;
- Total return for each reporting class taken as a whole (Total Return);
- Ratio of expenses, both before and after the incentive fee, to average net assets for each reporting class taken as a whole (Expense Ratio);

*continued on page 14*

- Ratio of net investment income (excluding the incentive fee) to average net assets for each reporting class taken as a whole (Net Investment Income Ratio); and
- Other disclosure information.
- The Total Return is not annualized;
- The effect of certain fee waivers must be disclosed; and
- Fund of Funds, Master Funds and Feeder Funds have certain specific unique requirements.

---

## Method of Calculation

Total Return for capital based hedge funds is calculated by comparing the aggregate ending value of each class of investor with the aggregate beginning value of each such class, adjusted for cash flows related to capital contributions and withdrawals during the period. Total Return for unit or share based hedge funds is calculated by dividing the change in unit or share value for each reporting class during the period by the beginning of period unit or share value for such reporting class.

The Expense Ratio for both capital based and unit or share based hedge funds is calculated by taking the total expenses (both before and after the incentive allocation or fee) attributable to the reporting class and dividing it by the average net assets of the reporting class during the period.

The Net Investment Income Ratio for both capital based and unit or share based hedge funds is calculated as the sum of all interest income, dividend income and other income from miscellaneous sources (*i.e.*, all non-trading or investing related income) minus all expenses (Net Investment Income) and then dividing the Net Investment Income by the average net assets of the reporting class during the period. For both capital based funds and unit or share based funds, the Net Investment Income Ratio excludes the incentive allocation or fee attributable to the applicable reporting class.

The above are the general calculation requirements for Total Return, the Expense Ratio and the Net Investment Income Ratio. GAAP requires adjustments, modifications, specific treatment and/or additional disclosures in certain instances. Several of the more significant items that require adjustment, modification, specific treatment or additional disclosure are as follows:

- The Expense Ratio and the Net Investment Income Ratio must be annualized for reporting periods of less than one year;

---

## Benefits and Limitations

Since the 2003 requirement for hedge funds to present financial highlights in their financial statements, financial statement users have been provided with better information regarding the operating performance of hedge funds, primarily presentation of Total Return and the Expense Ratio, and more information to help them compare financial data among hedge funds. For instance, prior to 2003, the financial statement user had no way of determining how net income or net loss translated into a rate of return. In fact, a hedge fund could have had significant net income, but still have produced a negative rate of return (or vice versa). However, the financial statement user would have only known that the fund had significant net income, thus leading such financial statement user to assume that the fund had produced a positive rate of return. The Expense Ratio has also tended to provide more useful information regarding hedge fund expenses and the impact of such expenses on the Total Return.

There are, however, many limitations to financial highlights. Although certain disclosure is required by GAAP regarding certain of these limitations, these limitations are not always apparently obvious.

One significant limitation is that the financial highlight calculations are "aggregate calculations." It is not uncommon for a hedge fund manager to waive or reduce management fees or incentive allocations or fees for certain investors. In calculating the financial highlights, the performance of investors who pay full fees and those that pay reduced or no fees are aggregated together in calculating the various financial highlights. Thus, in this situation, the financial highlights presented will produce blended results that do not match the actual experience of any one investor in the fund. The actual results of both a full fee paying investor and the reduced or non-fee paying investor will differ from the actual results presented in the financial highlights.

*continued on page 15*

Another limitation is that the Expense Ratio and the Net Investment Income Ratio are annualized. For instance, let's take an example of two absolutely identical hedge funds: Fund A, which commenced operations on January 1, 2007; and Fund B, which commenced operations on October 1, 2007. One would expect that Fund A and Fund B would have very similar Net Investment Income Ratios. However, due to the method of calculation and annualizing the ratio of Fund B, Fund A will have a higher Net Investment Income Ratio. Why? Interest rates on interest bearing deposits were in a declining trend throughout 2007. Fund A, which earned actual interest income all throughout 2007, earned a higher average interest rate than did Fund B, which only earned actual interest income during the last three months of 2007. When Fund B's Net Investment Income Ratio is annualized, it inherently assumes that Fund B earned interest income throughout the year at the same rate it earned during the last three months of 2007. Since interest rates declined during 2007, Fund B will be annualizing a lower average interest rate, thus pro-

ducing a lower Net Investment Income Ratio than Fund A's Net Investment Income Ratio. The above examples are two very common examples of the limitations of financial highlights.

So what is the conclusion? Are financial highlights accurate and worthy of reliance or not? I would suggest that financial highlights provide a general indicator or approximation of the results of operations and financial ratios. However, the financial highlights should be utilized only with the understanding of their limitations and any fact specific circumstances applicable to the hedge fund for which they are presented. I would also suggest they be used in conjunction with other verifiable information. ©

---

*Arthur Bell Certified Public Accountants is a public accounting firm providing a full range of accounting, audit, tax and consulting services to the hedge fund and managed funds industry. E-mail: [ross.ellberg@arthurbellcpas.com](mailto:ross.ellberg@arthurbellcpas.com)  
Web: [www.arthurbellcpas.com](http://www.arthurbellcpas.com).*

## Climate Change Policy continued from page 12

**Advanced Technology Vehicles Manufacturing:** The incentive program for advanced technology vehicles manufacturing will be awarded to manufacturers of vehicles (or components designed for such vehicles) that meet a standard of at least 125% of the base year combined fuel economy, as well as new criteria pollutant emission standards. The funding for this program over the first five years is \$4.9 billion.

### Opportunities for Asset Managers

Given that the pool of funds created under climate change legislation is substantial – \$51 billion over the first five years at the generally agreed upon low-end allowance price of \$15/mtCO<sub>2</sub>e – U.S. climate policy should create a host of investment options for alternative asset managers. These might include traditional long/short equity options, potential carbon markets long/short, arbitrage or derivatives opportunities and direct investments in the energy and technology sectors. In addition, “next generation,” socially-responsible investment vehicles and fund of funds

may hold appeal for certain asset managers. Finally, depending on their strategies, asset managers may be interested in influencing the policy debate with an aim to securing favorable incentives and/or climate policy design features that will foster market growth of certain sectors, attract capital investment, or ensure the availability of carbon market finance options. ©

---

*Ben McMakin is senior director governmental issues at Van Ness Feldman. Janet Anderson is senior technology and policy advisor at Van Ness Feldman. Based in Washington, D.C., with an office in Seattle, WA, Van Ness Feldman is a law and policy firm focused exclusively on energy and environmental issues. The firm has twice been recognized by Environmental Finance magazine as a leading law firm in the U.S. carbon markets, and advises a wide range of energy, manufacturing, technology and trade association clients on U.S. climate policy, as well as on energy infrastructure project development. The firm produces a Weekly Climate Policy Update, available on its Web site at [www.vnf.com](http://www.vnf.com). The authors may be reached at [blm@vnf.com](mailto:blm@vnf.com) and [jma@vnf.com](mailto:jma@vnf.com), respectively.*