

AFP® Annual Conference



November 7-10, 2010 | San Antonio

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Reporting to the Board: Recent Trends in Investment Reporting

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Agenda

- Intro
 - Investment Process is Complex and Critical
 - Internal and External Constituents
 - Problems with Legacy Investment Process
 - Reporting to the Board
 - Practical Examination
 - Final Thoughts
 - Q&A
-

Intro

- Chris Gowney, Clearwater Analytics

- CFA, Business Development and Founding Partner



- David Atchley, Cisco Systems

- CFA, Senior Manager, Global Investments



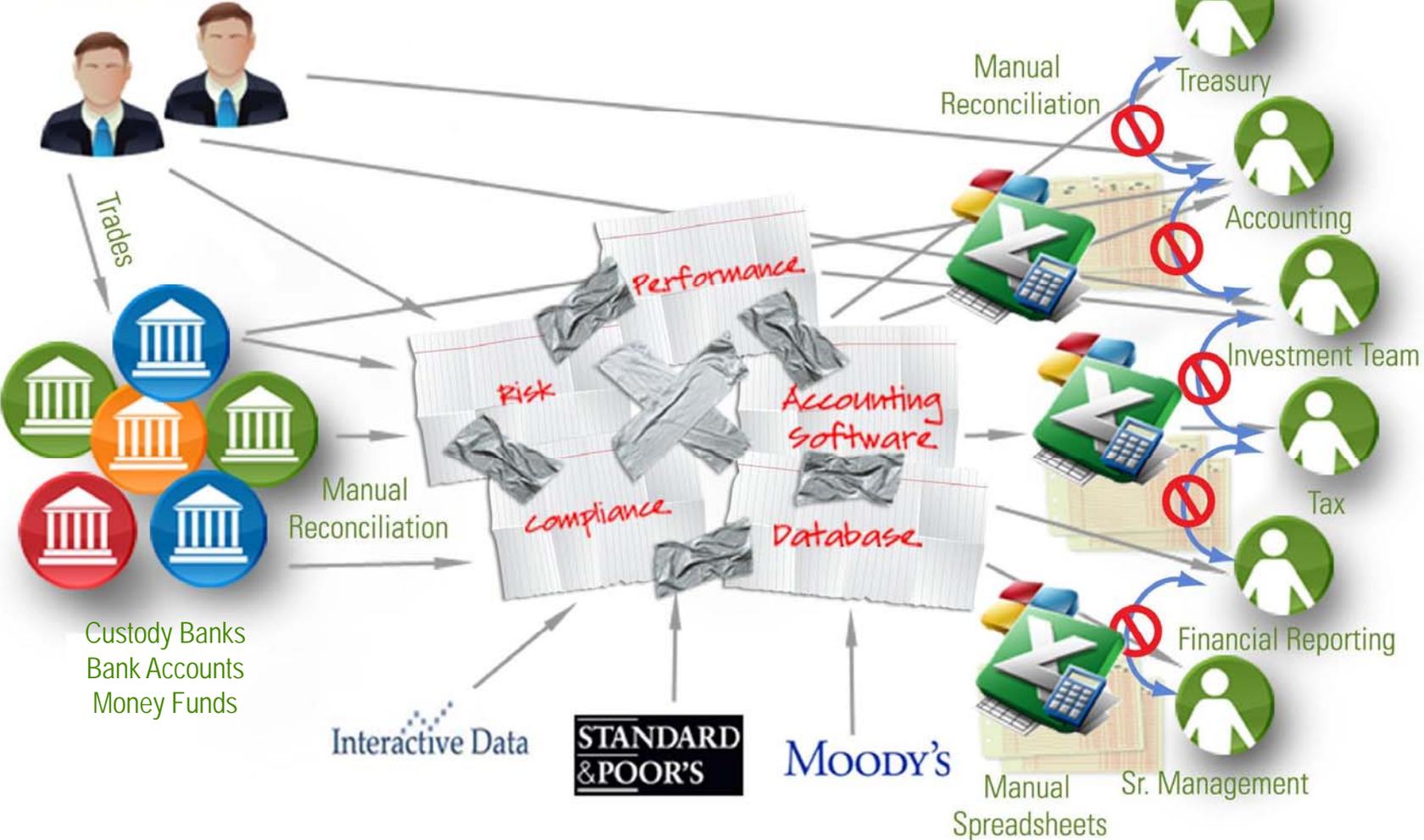
Investment Process is Complex and Critical

- Investment assets are at disparate locations
 - Requirement to aggregate, reconcile and report
 - Need for accurate, timely data
 - Different constituents, different needs, different levels of understanding
-



Ad hoc Investment Reporting

Investment Managers:
Internal and External



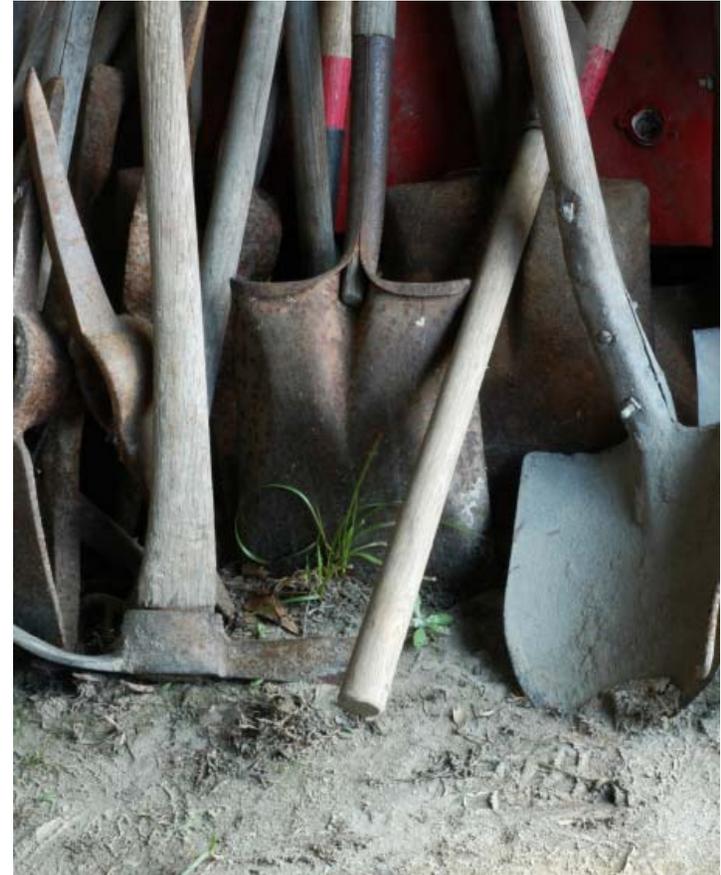
Internal and External Constituents

- Treasury
- Tax
- Audit
- Accounting
- FP&A
- Management



Problems with Legacy Investment Process

- Investment policy historically used for risk assessment
- Written by treasury, approved by the board
- Manual reporting is subject to manual entries and prone to error
- May not be fully understood at the board level



Reporting to the Board

- Get face time
- Send updates
- Be relevant
- Be thorough, but don't overload



Reporting to the Board

- Having the right information
- Educating the board
- Time constraints
- Reporting catalysts



Practical Examination

- Cisco Systems
 - \$40b portfolio
 - Managed conservatively
 - Active M&A strategy
 - Active share repurchase program
 - Staff of 4
 - 12 external asset managers
 - Multiple reporting benchmarks and formats
 - A need for seamless integration

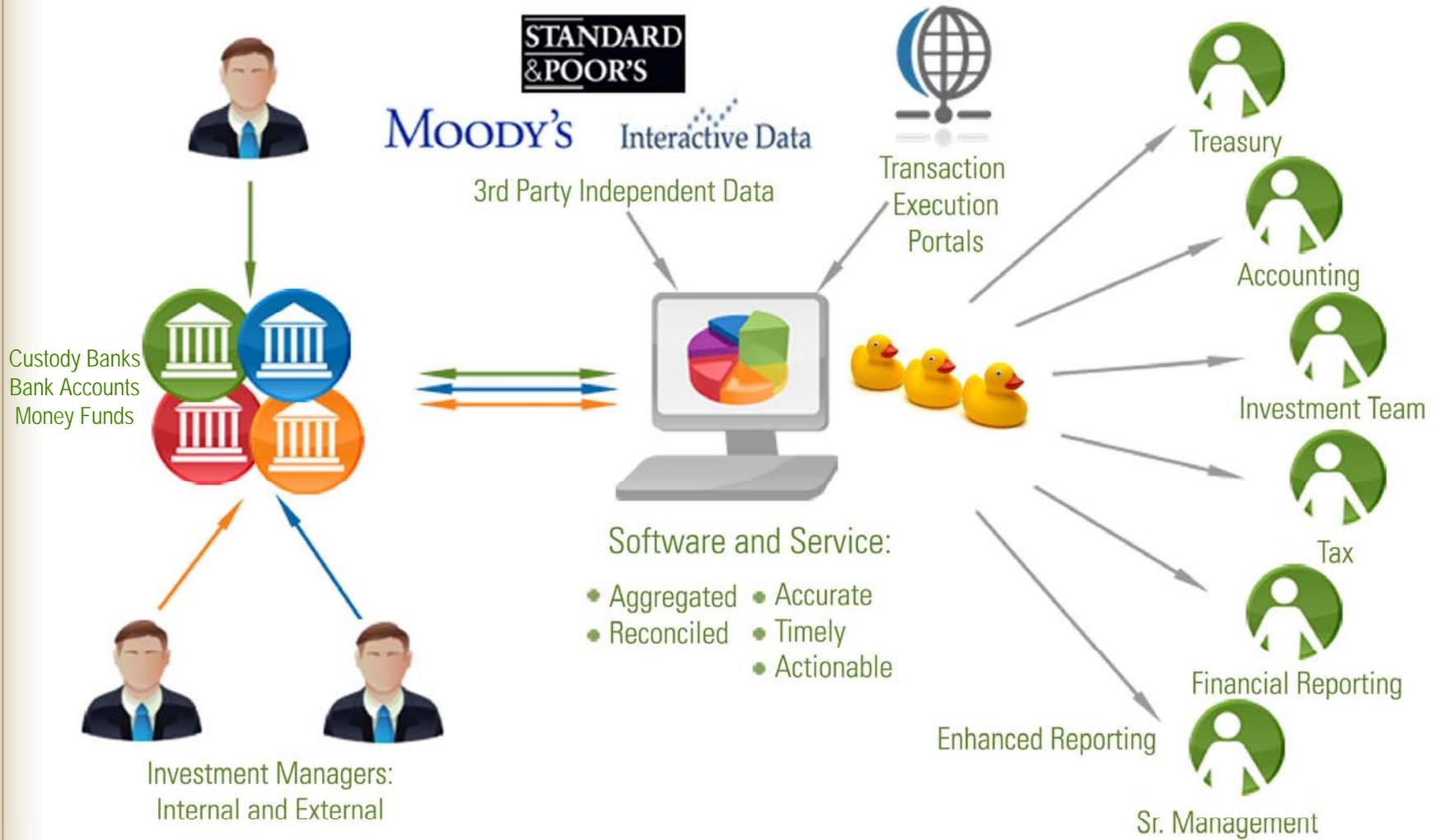


Practical Examination

- CFO and Board want summary-level data
- Report on key objectives
 - Portfolio Risk
 - Asset Class Allocation
 - High-Level, Fixed-Income, Sector Allocation
 - Public Equity Detail
 - Accounting
 - Total Return
 - Key Risks



Integrated Investment Reporting



Final Thoughts

- Integrated = The New Standard
- Reconciled to a single source
- Numbers that tie out
- Summary-level data
- Outsourced reporting?
- Good info = good decisions



Q&A

Questions?





Reporting to the Boardroom: Recent Trends in Investment Reporting

AFP Annual Conference 2010
Presentation Materials



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Reporting to the Boardroom: Recent Trends in Investment Reporting

Looking Across Disciplinary Divides



The investment reporting environment has always been complex. The financial crisis of 2008 and recent accounting developments have only made it more so, calling for new system solutions that cut across compliance, accounting, performance evaluation and risk analytics.

If historically, companies relied on divergent systems to handle their various reporting needs, increasingly corporate investors are looking for integrated solutions that not only provide an independent check on valuation but also a single view into these four areas in order to come up with both pre-trade and post-trade reporting that supports decision making, provides accurate accounting and financial reporting, monitors compliance and provides dynamic reports on performance.

Further shaping reporting requirements are the divergent needs of various constituencies within the organization, each with their own information “biases and data appetites,” accentuating demand for timely and complete information throughout the investment process.

The Investment Life Cycle

Historically, investment reporting was mostly concentrated in the post-trade phase, namely the need to record investment decisions for financial accounting and reporting purposes. Companies had to do the accounting for their investment portfolio and record gains and losses to their general ledger. The reporting capabilities of legacy systems focused on producing these numbers on an ad hoc basis.

But this trend is changing. “Over time, particularly in the last couple of years, there’s a growing demand to use the investment information to look at risk prospectively,” says Chris Growney CFA, Business Development and Founding Partner at Clearwater Analytics. Companies have begun demanding portfolio performance information in the pre-trade phase of the investment process, where investment decisions such as asset allocation are taking place.



The Investment Life Cycle / Reporting Information Loop

Companies want to look at their portfolio risk relative to the market, their cash flows and their funding sources, which has resulted in a significant change in how people look at information recording both in terms of the type of information that’s required and in terms of its timeliness.

Thus, reporting requirements now span the entire life cycle of the investment process, from decision support to compliance and financial reporting, creating an investment-information loop (see Investment Life Cycle diagram). In addition,

investment reporting is consumed by various constituents within the organization. Satisfying their divergent needs is a great challenge for corporate investment managers within treasury departments, and a major driver of developments in investment management systems.

Internal Vs. External Constituents: There are two types of investment information consumers: internal (within finance and treasury) and external (everyone else, including accounting, tax, Financial Planning & Analysis (FP&A), Internal Audit and Senior Management). Each group has its own specific needs, which dictate the reporting type and format.

Treasury: In essence, treasury's quest is to optimize risk-adjusted returns. To fulfill its mandate, it requires a full suite of investment management reporting, from accounting information (what's in the portfolio), to risk analytics (what is the risk across the portfolio, asset classes and all the way down to individual security level), whether the portfolio is in compliance with investment guidelines and how the portfolio and individual mandates are performing against the benchmark and against each other.

Accounting and financial reporting: Here the demand is for pricing to create appropriate credits and debits to the G/L – realized and unrealized gains and losses. Accounting requires impairment and fair value information in order to make the correct bookings to the G/L and is charged with keeping up with the latest Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) pronouncements that affect how the G/L entries are booked.



Recent changes in accounting rules, specifically fair value accounting under FAS 157 and impairment rules under FAS 115-2, have posed new challenges to treasury, accounting and thus investment reporting solutions. Fair value and impairment affect the value of the portfolio and how unrealized gains and losses are recognized in financial statements. An added complication is the advent of international accounting standards which, according to the most recent reports, will become mandatory for large US companies in 2014 (which means they have to begin collecting data in 2012).

Tax: Precisely how complex the tax department's mandate will be depends on the number of jurisdictions in which the company has cash. Many US companies, like Cisco Systems, (see case study) hold much of their cash offshore, creating tax consequences. In addition, even within the US, tax must know how much of the cash resides in various jurisdictions as well as the specific breakdown of interest income from various municipal bonds.

FP&A: FP&A has the task of forecasting investment income, an important line that affects earnings per share (EPS) and is therefore closely watched by management. Forecasting interest income 90 days out may be more an art than a science and this is why FP&A is a factor on both the pre- and post-trade phases of the investment life cycle. It's a post-trade forecast based on the portfolio positions and a pre-trade driver since securities will have to be sold in order to meet the number if the income falls short of expectations, as management attempts to "hit" its earnings forecast. "The reality of EPS forecasting is that if you are off, you need to take some action," said Clearwater's Growney. "As a result, interest income forecasting is a huge deal, in particular for companies with sizeable investment portfolios."

Internal audit (IA): The focus of internal audit is driven by recent events (like the Madoff affair) as well as Sarbanes Oxley Act (SOX). IA needs to know where the money resides and whether there are appropriate controls around it, in particular segregation of duties. Previously, at hundreds of organizations, the same person traded, settled, moved the money and produced the reporting. SOX and external changes have put an end to this sort of structure. Not only does IA focus on internal controls but it is also concerned with the way the company interacts with external parties, such as software providers and investment managers. “There are a fair amount of auditor-related process controls related to investment logistics,” Growney explained. “Making money is one thing. Having a good process is another.”

Reporting Up the Food Chain



The sixth and final constituency is arguably the most important – senior management and the Board. Just how much information management requires will be driven by its management philosophy, which, in turn, is often a function of how much free cash flow the company generates and thus, the relative size of its investment portfolio. Clearly, all management teams have a need to know. They need to know how much cash they have and to how much risk their cash is exposed. Less active management often have a “check the box” mentality. They are focused more on the ad hoc reporting capabilities, such as counterparty credit risk, compliance and performance information.

Meanwhile, more active management teams are balance sheet focused. “Management teams on the active side take the data and use it in various formats and aggregate it with other capital markets information to make funding and capital structure decisions,” Growney explained. The idea is to be operationally nimble and take advantage of opportunities as they arise. “For more engaged management teams, clearly it [investment reporting] is a part of the bigger puzzle,” Growney said. “It’s a strategic discussion.”

Regardless of management philosophy, there are three main challenges to reporting “up.” The first is the frequent lack of reliable data. The second is education. The third and final is timing.

Having the Right Information

First, treasurers don’t often have accurate or timely information. Often, data is incomplete (excludes money funds for example) or not detailed enough (ignores underlying security risk). “The challenge is that data often comes from different systems or different providers, making it difficult or impossible when it comes time to combine it and present it,” said Growney.

It also makes it hard to turn the data around for regulatory and other reporting purposes. “This is a big challenge because of the various providers involved (managers, custody, money market funds, etc), the generally low value of standard investment reports and the long delay in receiving them,” Growney said. The biggest risk is combining investment reports from different platforms that use



different accounting assumptions. For example, Manager A does conservative accounting and Manager B does liberal accounting. It is simply wrong to sum up reports from two providers that are using diametrically opposed accounting assumptions (similar to adding depreciation numbers using different assumptions).

Often, discrepancies in data sources can contribute to reports that do not hold up to even the simplest management scrutiny. The issue normally arises when one board report cites a figure for Total Value that differs from the figure in another report and the board asks why. “The board expects the accounting information to be correct. The board expects that the risk data it’s using to make and monitor decisions is correct,” said Growney. When the numbers are different, the assumption is one is not correct. “This is uncomfortable for everyone.”

The solution to avoiding these data discrepancies lies in integration. “Our goal is to consolidate as much as we can within one system to make decisions and to report out,” explained David Atchley, Senior Manager, Global Investment at tech giant Cisco Systems (see related case study). To ensure consistency, Cisco uses the Clearwater solution to spot-check data from other providers. “Accounting data is checked against our book of record. Performance data is checked against manager reporting. There’s an acceptable level of variance, beyond which it’s important to investigate the cause of the inconsistency. There’s a second set of eyes on most of our key metrics,” Atchley said. As a result, data reported to the Board is accurate and consistent. And data used for risk analysis, performance measurement and compliance ties out to the accounting data.

Using a single system means Cisco can close its books weekly (on Friday) based on Thursday closing prices. It faces no turnaround issue with regular reporting. A lot of the reports are built directly into the system and for others, “we created a process to work around that.” The only occasion when things may take longer is when there’s a special request and data has to be presented in a new way.

Educating the Board

The second challenge is that the Board often doesn’t have a full understanding of the investment-related risks, what questions to ask or on what measures to focus.

“The biggest distortion comes from the lack of understanding,” Clearwater’s Growney said. Much of that results from complex impairment rules and fair value accounting under FAS 157 (now ASC 820). There are simple issues, for example understanding that there is more than one price for a single bond and that bonds are not traded on an exchange. Uneven levels of understanding along these various constituencies puts treasury in a precarious position; how do you explain to the chief accounting officer that he or she doesn’t understand impairment? “It’s imperative that treasury have the right tactical tools and means to report the information in order to affect a wholesale understanding in that regard,” Growney explained.

Both the materials presented and the type of conversation treasury has with the board evolve as the portfolio grows and as its dynamics change. For Cisco, too, it has been an



evolution. Presentations evolved over time to focus on the finance committee of the board's key concerns and to present the information in the most useful way. "We like to meet with new members up front to cover the key metrics and data so they are up to speed with how we view the portfolio and measure our performance," Atchley said.

It is treasury's responsibility to educate up and push the right information into the right hands, be they management, Internal Audit, FP&A, tax or financial reporting. When education fails, a disconnect can lead to undesirable portfolio management decisions. "That's what happened in 2008 when companies liquidated their portfolios on a wholesale basis and moved their holdings into money market funds," said Growney.

Time Constraints

Board members often go from meeting to meeting and have a lot of information to cover. "We make sure we present the right level of information for our Board and our portfolio reporting is on a high level, focusing on how we are performing vs. key policy objectives, any significant changes and key portfolio risks," said Atchley.

To stay within its allotted time, it's critical that treasury selects the right metrics to present to the Board. In general, it is a best practice to use the same data for managing investments and for reporting to the board; the board data is just a higher level view. Treasurers get in trouble if they use source A to manage investment decisions and source B for management-style reporting (but this is not uncommon).

When reporting on portfolio risk, the company's investment policy lists the relevant risks, making it a good place to start. If there is a limitation on credit rating, then monitoring and reporting credit rating makes sense. Accounting detail is always important, especially anything affecting the income statement or subject to high volatility (unrealized gain/loss).

"We need to use our time wisely," confirmed Atchley. "When we're talking about metrics, they are the same at the Board level and the treasury and investment team level. We call out the risks, and we call out the opportunities." A typical investment presentation agenda will include: cash and investments, portfolio overview, risk analysis, asset allocation, performance, and key risks.

Reports on compliance only make it to the Board level if the investment team is looking for an exception to the policy. On a regular basis, if a security falls out of compliance with the investment policy the manager is given a couple of days to sell it. Treasury of course monitors the compliance filters.



Accounting data does not make the cut except in the aggregate, i.e., what's actually hitting the P&L or what large unrealized gains or losses exist in the portfolio. "This is all in summary level format for the entire portfolio," Atchley said.

While it's helpful to have a set deck that the Board can see every time, it's important for treasury to remain flexible and address top-of-mind issues as they emerge. One recent example involves exposure to financial names. That's a topic that gained interest with the financial crisis and required a special focus at Board meetings. "We specifically and proactively reported on finance exposures and discussed issuer-level details," Atchley said.

Reporting Catalysts

Recent events in the financial markets have only served to highlight the importance of integrated, accurate and timely investment reporting. The crisis of 2008 has heightened management needs for better information down to individual security-level and to have that information at their fingertips, posing a challenge for investment reporting solutions.



"There's a great push for live information," Growney said. Historically, management and investment professionals did not need reporting information on a daily basis, but events such as the collapse of Lehman accentuated the need to be able to run risk reports on the fly to identify issuer concentration risk, for example. In an active finance organization, such real time information drives decision making on a continuous basis, whereas in the past it was sufficient to look at risk parameters on a less frequent basis. "Timeliness is important for pre-trade decisions," Growney said.

Concurrently, there's a change in the type of information required. Transparency is in demand both internally and externally. The response goes beyond corporate needs and has led to new SEC regulations, in particular of money market funds. Now, treasury and management want to know what is inside the fund, what percentage is in commercial paper, and if there are any asset-backed backed securities in the mix. The granularity of information has expanded considerably.

"In general, there's a much deeper demand to know what you own and know what your real risks are," according to Growney. On the risk side, he said, "management felt blindsided (in the wake of the Lehman crash). No one wants to be caught in that position again." Internal and external constituents are widening their view regarding the level and type of information they need access to. People are asking what is in their money market funds. What types of embedded options are in the securities they own? Management wants to know what constitutes the risk within a security or a fund to make sure they address that sort of risk.

Another key area for risk analytics lies in counterparty credit risk. What is the concentration of the portfolio in finance, for example? "That type of information is core to good investment," Growney said. "You need to know what you own for risk management purposes and not only where the exposure is, but why it's there. As a result, there's an enormous amount of demand for more visibility and transparency across the spectrum."

But having more information is useless without the tools to navigate that information. “If you gave me a diagram of a car and showed me which part is broken I wouldn’t be able to use that information to fix it,” explained Growney. There’s therefore a need to create context for the information through better reporting. If a security is out of compliance, it’s important to be able to track down the reason to a downgrade, for example, to understand the drivers and make decisions about selling or holding it. If there is a large unrealized loss in the portfolio, it is critical for treasury to be capable of demonstrating the drivers of that loss and whether they are temporary or not and if not, what it intends to do about it.

“People are starting to know what they don’t know,” Growney said. Information without context provides no intelligence. In order to make savvy investment decisions, treasury and management need systems that not only ensure data richness and integrity, but also offer the solutions that make sense of that data in terms of risk management and performance. For example, it’s one thing to see that a manager is performing badly against a benchmark. It’s another to understand why. It’s one thing to see that the portfolio duration is changed, but it is important to understand why a manager, for example, is taking a duration bet.

To this end, there is an increasing trend towards outsourcing of investment reporting, as well as an understanding that companies must hire professionals with investment expertise. “You cannot just put anybody in charge of a multi million (or billion) cash portfolio.” So the need to turn information into knowledge is driving both system and hiring decisions. The objective is to be capable of interpreting the data and making sense of it; not just for treasury’s use but for external constituents as well. “You need to take data, turn it around and explain it up the food chain,” said Growney.

Conclusion: A Holistic View

If there’s one term that exemplifies the new reality of investment reporting it is “integration,” or the ability to use a single source of data (reconciled to provide an objective check on custodial bank information) to pull together dozens – if not hundreds – of reports that are customized for the needs of the various constituents within the organization and across the entire life span of the investment process, from pre-trade decision support to post-trade reporting. Traditionally, these reports if available at all were produced by standalone systems, which did not cross-reference one another. But advances in accounting, as well as greater awareness of risk, have driven the marketplace toward a single solution capable of answering cross-disciplinary questions.

“The need to link accounting and risk analytics in particular is a big catalyst of today’s reporting environment,” said Growney. Even two or three years ago, “accounting did accounting and treasury did performance evaluation and risk analytics.” Now the two must converge to produce the knowledge treasury and management need to fulfill their mandate. “Now, with impairment and the need to assess the quantitative and qualitative impact of the negative unrealized loss, the two groups must look at numbers across the disciplinary divide,” Growney concluded.



About Clearwater Analytics

Clearwater Analytics® provides web-based, investment portfolio reporting and analytics for institutional investors, investment managers, custody banks, and electronic trading portals. With solutions for both separately-managed and commingled accounts, Clearwater Analytics delivers the highest level of portfolio transparency available on the market today for clients such as Cisco, Oracle, Starbucks and Yahoo! Launched in 2004, with offices in New York and Boise, Idaho, Clearwater Analytics reports on more than \$500 billion in assets for 2,500 institutional investors.

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CASE STUDY

GOING BIG WITH VERY LITTLE: HOW CISCO MANAGES \$40B WITH A STAFF OF FOUR

"The power of our outsourced portfolio reporting and analytics system is that we can see all of our key metrics in one place – risk, accounting, performance, and compliance – without spending time pulling data from multiple sources, aggregating it and reconciling it. All of our time is spent discussing and executing strategy."

-- David Atchley
Senior Manager of Global Investments
Cisco Systems

Integrated System, Lean Staff

Cisco Systems manages an investment portfolio of \$40 billion with a staff of four. How do they do it? They rely on a web-based, investment portfolio reporting and analytics solution that combines detailed accounting data with state-of-the-art analytics, to create a live view into the portfolio performance, risk profile and compliance with the company's global investment policy. The same tool also enables Cisco's investment team to anticipate and answer management questions and provide an overview of performance and risk to senior management and the Board.

"The power of our outsourced portfolio reporting and analytics system is that we can see all of our key metrics in one place – risk, accounting, performance, and compliance – without spending time pulling data from multiple sources, aggregating it and reconciling it" said David Atchley, Senior Manager of Global Investments. "All of our time is spent discussing and executing strategy."

Background

While the \$130 billion company (market cap as of FY10 year-end) has a sizeable cash and multi asset-class investment portfolio, it also has substantial liquidity needs:

- Cisco repurchased common stock of \$7.8 billion during FY10 (a total of \$65 billion since 2001 of a \$72 billion authorized program)
- Cisco remains a highly acquisitive company, announcing six acquisitions and funding \$5.3 billion of acquisitions during FY10 (139 acquisitions either announced or closed since the company started)

Cisco calculates its liquidity conservatively. Like many high tech firms, most of its cash (80%) is held offshore, whereas most of its cash needs are in the US. For internal purposes, the company targets specific ranges of net realizable cash. Cisco calculates net realizable cash by taking all cash and cash equivalents and subtracting (1) short-term and long-term debt and the present value of lease commitments; and (2) estimated US income taxes that would be payable if offshore cash were to be repatriated.

Cisco is a \$146 billion company with a sizeable cash and investment portfolio with substantial liquidity needs, as it remains a highly acquisitive organization, with over 139 acquisitions since the company started.

In order to meet all of these liquidity needs, while maintaining a solid position for the future, Cisco is constantly optimizing its liquidity management. Key to the strong cash and investment position is the manner in which Cisco invests its cash. The management philosophy of these assets is based on three main objectives: first, preserve capital, defined as having a high confidence in avoiding negative returns over a one year horizon; second, provide a high risk-adjusted rate of return consistent with the first objective; and third, keep the portfolio invested in easily-convertible, liquid securities to meet the strategic cash demands of the business. Delivering on these three main objectives is crucial to the company's liquidity management strategy. The investment team's mandate is to "efficiently allocate assets across multiple asset classes in order to deliver optimized returns," said Atchley.

"While we are willing to take some risk in equity, credit and optionality, we're not willing to take excessive liquidity risk," Atchley explained. This focus on capital preservation, risk-adjusted return, and liquidity steered Cisco clear of some of the more problematic asset classes over the past couple of years, such as extendible asset-backed commercial paper (AB-CP) and auction-rate securities and allowed its portfolio to successfully weather the financial turmoil of 2008.

Seamless Connectivity

Cisco's reliance on a dozen external managers, its diversified portfolio and small treasury investment team form the backdrop for its reporting requirements, which span the entire investment process, from pre-trade investment decision making, to post-trade compliance and financial and management reporting.

To this end, Cisco relies on an outsourced portfolio reporting and analytics system to pull in the position, transaction and accounting data from the company's custodian and book of record, reconcile the portfolios using independent security master information and feed the integrated performance, compliance and risk modules, where additional number-crunching and reporting take place.

Its outsourced portfolio reporting and analytics system is able to deliver the information Cisco needs because it merges the custody accounting data with its own analytics, compliance and performance functionalities to provide a complete view across the entire portfolio. The integrated model gives Cisco the ability to understand what its managers – both internal

and external – are doing vis-à-vis their benchmark, where they are taking their risk, whether they are long or short duration at the individual account level, across the mandate and across the entire portfolio. It's this cross referencing capability that enables treasury to track key risk indicators, (i.e.: total return, risk models such as Value at Risk (VaR), asset allocation, and accounting data, such as unrealized gains or losses) at the individual account and macro levels, across the entire portfolio.

Reporting Up

This analytics engine also drives the way Cisco reports to management. While all the way up to the Assistant Treasurer level, the system is used as a functional tool, when it comes to discussions with the Treasurer, CFO and the Finance Committee of the Board, the outsourced solution provides the cross-portfolio, summary-level information, which is dropped into dashboard views for senior management reporting.

"Our approach is to report out on our key objectives," Atchley said. "The board needs to know how we are performing (total return), the risk we are taking (standard deviation of returns), risk adjusted returns (Sharpe ratio), asset allocation, strategy and key risks."

A presentation to the Cisco Board may include the following information:

Portfolio Risk – A historical view of realized risk vs. the benchmark and long-term target. This data comes from the provider's performance module.

Asset Class Allocation – Summary information from Cisco's provider

High-Level, Fixed-Income, Sector Allocation - What percent is in government securities, credit, etc., again, from Cisco's provider

Public Equity Detail - Not at the security level, but at the mandate level.

"We go into a bit more detail here as Equity has a higher risk profile."

Again, Cisco uses data from its provider to make the pie chart on this slide.

Accounting - Unrealized and realized gain/loss – how it impacts the company's OI&E line. This comes from the custodian's system but is verified by Cisco's provider in an accounting module.

Total Return – Data for the overall portfolio looks at return, risk, risk adjusted, etc. This data comes from the provider's performance module.

Key Risks – One bullet-point slide highlighting some of the 'top of mind' issues – and "how we are positioning the portfolio," Atchley said.

The treasury team presents to the Board three times a year, but during the crisis in the financial markets, Cisco's outsourced portfolio reporting and analytics solution was also invaluable in enabling treasury to proactively answer management questions. "There were daily headlines that raised concerns," Atchley recalled. "Are we exposed to this name? Do we have those securities?" Using Cisco's outsourced portfolio reporting and analytics solution, treasury was able to anticipate and answer such questions and produce issuer concentration reports on the fly.

"The integrated model gives Cisco the ability to understand what its managers – both internal and external – are doing vis-à-vis their benchmark..."

Conclusion

Running a \$40 billion diversified portfolio with a staff of four is no easy task. To deliver on its mandate of optimal asset allocation, Cisco's investment team needs daily-reconciled information about the performance of its portfolio, and the ability to carve out specific risk characteristics to produce multiple reports focusing on duration, credit exposure and concentration risk (see sidebar – issuer concentration detail).

That seamless connectivity is where many other systems fail. That was one of the first things Cisco discovered when it set out to find a portfolio management tool back in 2003. "None of the other systems adequately marries the accounting and risk modules," Atchley said. "While economics always come first, we need to be aware of the accounting implications of our decisions as these can impact the P&L of the entire organization," he said. "Having the consolidated risk and accounting view of our portfolio in one tool enables us to manage the portfolio with a small staff."

About Clearwater Analytics

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TREASURY Topics

November 2010

Impact on Investment Accounting

Recent accounting changes have had a significant effect on investment reporting, specifically FAS 157 (fair value accounting) and the new rules governing when and where to recognize other than temporary impairment (OTTI) under FAS 115-2. While the first affected mostly the way companies report on their fair value calculations, the latter impacted G/L entries.

Also on the horizon for US reporting entities are changes in the way International Financial Reporting Standards (IFRS) handle classification and impairment, recently proposed as the first phase of IFRS 9 (designed to replace IAS 39). While IFRS implementation is less immediate (the SEC has committed to implementing IFRS for US companies in 2014), to comply US companies would have to start keeping records for IFRS reporting in 2012.

FAS 157

FAS 157 is the accounting standard that governs the way companies calculate fair value. Because most corporate investors are heavily weighted in liquid fixed income securities and some equities, it has had little impact on the way they actually calculate fair value. The real impact is in how they report fair value. Under FAS 157, companies must designate and disclose what level of pricing input they've used in determining fair value. Level 1 is the most transparent. Level 3 is the most subjective.

"Level designation ended up more subjective than was expected," said Rhead Hatch, General Ledger Manager at Clearwater Analytics, although auditors are slowly coming to a greater consensus on what constitutes Level 1 vs. Level 2 inputs. Therefore, it is important to allow users the flexibility to make their own choices. To this end, "The [Clearwater] system takes what users have determined is the level of input and produces the disclosures that are required and splits up their portfolio based on their designations."

OTTI

The process for determining other than temporary impairment has changed under FSP 115-2. Previously, in cases other than credit impairment, a security was deemed other than temporarily impaired if the company did not have the ability or intent to hold it to maturity or recovery. The intent to sell, even absent an actual sale, resulted in OTTI and a hit to earnings.

Since 2009, the test has become less subjective. Regardless of the security's fair value, if the discounted

cash flow (NPV) of the security is greater than or equal to its amortized cost and the company will more-likely-than-not hold the security to maturity or recovery, there's no OTTI. Changes in the fair value go through OCI, not income.

However, "If the sum of discounted future expected cash flows is less than your amortized cost, you cannot say you will recover your full investment, regardless of intent. The difference between the NPV of the future expected cash flows of the security and its amortized cost is the credit impairment, which needs to be booked through income," said Hatch.

IFRS

Currently, IFRS and GAAP are pretty similar in the way they handle investment accounting, allowing for three designations: trading, available for sale (AFS) and held to maturity (HTM). Each determines where to book realized and unrealized gains and losses. Both IFRS and US GAAP provide the option to book gains and losses through income and OCI, depending on the designation.

"Both the IASB and the FASB recently published their proposed changes to the current set of rules and what's most interesting about the proposals is how they diverge in their approaches," according to Hatch. FASB is trying to eliminate the HTM category, which allows companies to carry securities at amortized cost. The IASB, in contrast, is attempting to eliminate the available for sale (AFS) category, a halfway house that allows running some gains and losses through OCI. "Instead of convergence, we're witnessing divergence," Hatch said.