

K&LNG Alert

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Investment Management The CFA Institute Issues Guidance Statement on Performance Examinations under the Global Investment Performance Standards (GIPS)

The CFA Institute recently issued a Guidance Statement on GIPS Performance Examinations (the “Guidance Statement”)¹ to ensure consistency of the procedures followed when an investment management firm chooses to have a “performance examination” conducted on one or more of the firm’s composites. A performance examination is the detailed review of a specific composite by an independent, third-party “verifier”. The scope and purpose of a performance examination is to test whether an investment management firm has constructed and calculated the composite in compliance with GIPS standards, and whether the firm presents the composite in compliance with the GIPS standards. Currently, the GIPS standards do not require verification or performance examinations. However, an investment management firm that chooses to have a performance examination conducted will be required to follow the GIPS guidelines.

VERIFICATION

Verification is the review of a firm’s performance measurement processes and procedures by an independent third-party verifier. A performance examination differs from a verification, as a performance examination maintains a composite specific focus and a verification maintains a firm-wide focus. The purpose and scope of a verification is to confirm firm-wide compliance with the GIPS standards, in regards to composite construction and performance measurement processes and procedures. A performance examination is a further, more extensive, specifically focused examination of a specific composite and its presentation.

If a performance examination is conducted, an investment management firm must, either first or concurrently, have a verification conducted. If a verifier agrees to issue a performance examination report that covers a longer period than the verification (the “extended performance examination report”), this period should not be more than 12 months beyond the date of the verification report.

An extended performance examination report and composite presentation should clearly disclose: (a) the lack of verification for the extended period of time; and (b) that the extended performance examination report may only be distributed to a prospective client requesting the report. Both the Guidance Statement and the adopting release to the Guidance Statement imply that an extended performance examination report may only be distributed pursuant to a request for proposal or other client request.

FORMAT

An investment management firm may not claim that a composite has undergone a performance examination with respect to the GIPS standards, without first obtaining a performance examination report from a verifier.

This performance examination report prepared by a verifier is not required to follow a particular format. However, it generally includes the following:

- the name of the composite examined;
- the time period covered by the report;
- the verifier’s opinion that the composite was constructed, calculated and presented in compliance with the GIPS standards; and

¹ The Interpretations Subcommittee of the GIPS Executive Committee develops guidance statements to give additional interpretation and/or clarification on issues that are new, novel, or beyond the scope of the simple application of the GIPS standards.

- information that the report is for a performance examination and conducted by the verifier in accordance with the Guidance Statement.

If a verifier concludes that the composite presentation does not satisfy the GIPS standards, the verifier must issue a statement to the investment management firm clarifying the reason(s) why it was not possible to provide a performance examination report.

REQUIRED PROCEDURES

Verifiers must comply with certain procedures when issuing a performance examination report. The following is a highlight of these procedures:

- Pre-Performance Examination Procedures. A verifier that did not perform the firm-wide verification must have knowledge of the firm, the GIPS standards, the applicable country-specific laws and regulations and the investment management firm's policies used for the composite when establishing and maintaining compliance during the period examined.²
- Sample Portfolio Selection. A verifier may check compliance with the GIPS standards by using a selected sample of the composite's portfolios. The verifier conducting the performance examination must determine the appropriate sample size, and reasonableness of the sample selected.
- Performance Examination Procedures. A verifier should examine:
 - *Cash flows, Income and Expenses, and Portfolio Trade Processing* to determine whether each is recorded in the proper portfolios, at the correct amounts, and on a timely basis that is consistent with established policies. Procedures should be considered and performed at a level that satisfies the verifier that each of the above items is supported by documentation and the methods used to account for each item are appropriately and consistently applied.
 - *Portfolio Valuation* to determine whether the beginning- and end-of-performance measurements period valuations of security positions are valued correctly and on the correct dates.

- *Performance Measurement Calculation* to determine that portfolio and composite returns have been correctly calculated.
- *Composite Presentation Information and Disclosures* to determine whether the presentation includes all the information and disclosures required by the GIPS standards. Investment management firms must determine that the presentation also complies with applicable regulatory requirements.

- Maintenance of Records. A verifier must maintain sufficient information to support the performance examination report.
- Management Representation Letter. The verifier must obtain a representation letter from the firm confirming that the composite being examined is in compliance with the GIPS standards, in relation to the following areas: (1) the composite construction; (2) the composite calculations; and (3) the composite presentation and preparation. This letter should also confirm any other specific representations made to the verifier during the examination.³

CONCLUSION

The Guidance Statement on GIPS Performance Examinations can be found on the CFA Institute website at www.cfainstitute.org/centre. The Guidance Statement includes a sample report that is compliant with the Guidance Statement provisions. Firms that engage in a performance examination of a specific composite that covers performance for periods ended December 31, 2006 must apply the new Guidance Statement. The Guidance Statement requires no retroactive application.

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² A firm that performed a firm-wide verification is already required to meet this requirement.

³ The investment management firm is responsible for fully disclosing any information to the verifier that might affect the work of the verifier performing the performance examination.

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