

## INVESTMENT PERFORMANCE COUNCIL (IPC)

### INVITATION TO COMMENT:

#### **Guidance Statement on Error Correction**

The Investment Performance Council (IPC) and CFA Institute seek comment on the proposals set forth below regarding the addition of a GIPS Guidance Statement to address the correction of errors in performance-related information. For information on the Guidance Statement process, please see <http://www.cfainstitute.org/standards/pps/process.html>.

Comments must be submitted in writing and be received by CFA Institute no later than 28 February 2005. All comments and replies will be put on the public record unless specifically requested. It is preferable that comments be submitted in electronic form with settings that do not restrict the ability to 'cut-and-paste' text from the comment letter. Comments are also accepted in hardcopy and should be addressed to:

CFA Institute  
CFA Centre for Financial Market Integrity  
Reference: Guidance Statement on Error Correction  
P.O. Box 3668  
Charlottesville, Virginia 22903  
Fax: 434-951-5320  
E-mail: [standardsetting@cfainstitute.org](mailto:standardsetting@cfainstitute.org)

#### **Effective Date**

This guidance statement will apply to all firms from the Effective Date forward. The proposed Adoption Date for this Guidance Statement is September 2005 and proposed Effective Date is 1 January 2006.

#### **Executive Summary**

The GIPS standards do not currently address the issue of accuracy; however, even with the tightest of controls, errors will occur. Firms that claim compliance with the Standards are faced with addressing situations where errors are discovered and specifically addressing the adjustments that should be made to prior period returns and previously reported GIPS-compliant presentations. Firms should consider the principles outlined in the Error Correction Guidance Statement when determining how to handle all types of errors.

#### **Comment Requested**

CFA Institute seeks public input on the proposals set forth in this document. Issues to consider in conjunction with this proposal include:

1. Do you support CFA Institute's effort to develop provisions to be added to the GIPS standards addressing the guidance of error correction?
2. Do you agree that the guidance should be applied to all types of errors?

3. Do you agree with firms not making retrospective changes to previously presented information?
4. Should the GIPS standards require firms to have documented policies and procedures for correcting errors?
5. Do you agree with the guiding principles provided to firms when determining how to handle errors?
6. Do you agree with the application questions and responses provided?

If commentators put forward other proposals, CFA Institute requests they explain how their proposals satisfy these objectives.

<b><u>Proposed Adoption Date:</u></b>	<b>September 2005</b>
<b><u>Proposed Effective Date:</u></b>	<b>1 January 2006</b>
<b><u>Retroactive Application:</u></b>	<b>No</b>
<b><u>Public Comment Period:</u></b>	<b>Oct 2004 – Feb 2005</b>

## **INVESTMENT PERFORMANCE COUNCIL (IPC)**

### **Guidance Statement on Error Correction**

#### **Introduction**

The GIPS standards do not currently specifically address the issue of accuracy; however, even with the tightest of controls, errors will occur. Firms that claim compliance with the Standards are faced with addressing situations where errors are discovered and specifically addressing the adjustments that should be made to prior period returns and previously reported GIPS-compliant presentations.

#### **Background**

Clearly, investment management firms use their portfolio accounting data as the basis for the rates of return they publish and report. Typically, prior to initiating the reporting cycle a reconciliation process is initiated against the “official books and records.” These records are normally maintained by the custodian, who is responsible for the integrity of the data. In some instances, the investment management firm also serves as the custodian. In other instances, the investment management firm and custodian are hired separately by the client. In either instance, normal practice is to reconcile between the investment manager’s and custodian’s records, at least monthly, if not more frequently.

For a variety of reasons, reconciliation differences (errors) are discovered that could result in an erroneous calculation of the rate of return for a specific portfolio which in turn results in an error in the composite return. Errors can be caused by, but are not restricted to:

- Missed trades: Perhaps a trade was processed against the wrong account or wasn’t correctly registered on either system.
- Mishandling of corporate actions: On occasion, a corporate action may have been missed completely or simply not processed correctly.
- Missed cash flows
- Pricing problems: A particular problem for securities that aren’t actively traded or for which market prices aren’t available and for which manual prices are entered.
- Exchange rate problems

Other types of errors include, but are not limited to:

- Incorrect allocation of portfolios to composites;

- Index returns, customized or externally published, presented incorrectly;
- Misstated composite assets, composite dispersion, or other disclosures and/or presentation statistics.

Although this guidance statement is targeted to calculation errors, the concepts provided should be applied to all types of errors.

Once the investment management firm becomes aware of any error, they must decide what to do from a reporting standpoint. They must decide whether the firm should recalculate the previously reported performance and inform any and all recipients of the GIPS compliant presentation

This guidance statement is concerned only with error correction for GIPS compliant presentations; however, firms should consider whether they require similar controls for specific client reports.

*Some firms will determine not to make retrospective changes to previously presented information:*

1. Often they don't want to inform current and prospective clients of retrospective changes. They feel this will suggest that the firm doesn't have the correct controls in place and that any adjustments will raise concerns about processing and the information about changes will have little benefit to the client. This response, however, is not justified. Clients need to be aware that there will be occasions when prior period results will change and should be pleased that the investment management firm is willing to go back and make the necessary adjustments to insure the highest quality and accuracy of reported data.
2. The correction will have little or no impact on the previously reported numbers. Changes that may be considered "immaterial" may not be worth changing.
3. The error will be captured and corrected in a subsequent reporting period. This may often occur; however, this will impact any risk statistics derived from performance returns, and valuation errors - particularly if cashflows have taken place - may result in a permanent change in performance that is not corrected in subsequent periods. Materiality should still be considered

### **Guiding Principles**

The firm should consider the following Guiding Principles when determining how to handle errors:

- Develop written policies and procedures
- Proactively define materiality
- Develop and follow an error correction process

### Written Policies and Procedures

Firms must have written policies and procedures on how they handle prior period adjustments. These policies should be strictly adhered to. The presence of administrative controls is of utmost importance, as they will help minimize the need to make adjustments.

Firms may decide it is appropriate to issue GIPS compliant presentations only after the reconciliation process is complete.

If presentations are published prior to reconciliation, they should carry notation such as “preliminary numbers; changes may occur as a result of reconciliation (or “subject to change”)” to alert the recipients that the numbers haven’t been finalized; however, firms are reminded that all GIPS requirements remain in force for preliminary presentations

The written policies and procedures should include guidance on how quickly errors should be reported, and to whom, and should also include a definition of materiality.

#### Definition of Materiality

A decision to change or notify recipients of errors should be linked to the materiality of the correction.

Firms must define on an *ex ante* basis the size and impact of an error that would require a restatement (i.e., adjustment to prior periods without republishing to prior recipients) or republishing of previously presented information.

The size and impact of the error defined may vary for different asset types (e.g., equities, fixed income, emerging markets), reporting periods (e.g., monthly, quarterly, or annual returns) and time periods (e.g., prior to a specific date, more than 5 years ago, or in a “frozen” time period).

Firms should disclose that their policies and procedures on error correction are available on request.

Erroneous disclosure notes may also require the firm to consider republishing compliant presentations.

#### Error Correction Process

A firm should strive to create an unambiguous process including specific steps followed to not only discover errors but also to correct errors and how that information will be disseminated to all interested parties. For example a simplistic process may include the following steps:

1. Recalculate the returns.
2. Determine if the error is material.
3. Decide what action to take. Document the original figure, the corrected figure, and the action taken.

#### Reporting of errors (republishing) to prospective clients

All firms must have a policy and procedure in place to proactively report material corrected errors not only to their existing clients but to ANY prospective client that the firm believes relied

upon the incorrect information, including consultants and verifiers. As mentioned above the firm's materiality threshold should determine whether the firm merely restates performance or if republishing is necessary. Republishing is defined as making certain that ANY prospective client that the firm believes relied upon the incorrect information is updated with the correct information; a disclosure must also be provided to ensure that the prospective client fully understands the change. Restating is defined as correcting the error but due to the lack of materiality there is no requirement to inform prospective clients.

### **Effective Date**

This Guidance Statement is proposed to take effect 1 January 2006. Firms currently coming into compliance should apply this guidance to all periods. Firms are encouraged, but not required to apply this guidance prior to the Effective Date.

### **Applications**

- 1. We recently determined that our total firm assets disclosure for the past two years has been incorrectly reported in our GIPS compliant presentations, but the rest of the information in our presentations is correct. Does this qualify as an error?*

The concept of correcting for an error applies to all information included in a compliant presentation and not simply the composite returns. If the amount of firm assets was misstated by a material amount, considering your firm's definition of materiality, you should treat this as the correction of an error and report the correction to those prospective clients that received the incorrect information.

- 2. Our firm has claimed compliance with the GIPS standards for approximately 5 years. We have just taken a fresh look at our composite presentations and realized that we inadvertently excluded one of the required disclosures concerning the composite's creation date. We have corrected our presentations, and would like some guidance on whether a missing disclosure qualifies as an error.*

The lack of a required GIPS disclosure would be considered a material error. All firms must have a policy and procedure in place to proactively report corrected errors not only to their existing clients but to ANY prospective client that the firm believes relied upon the incorrect information, including consultants and verifiers.

- 3. We realized that an account had been included in the wrong composite for the past 5 years. We have corrected the account's composite assignment and recalculated the composite's return and related disclosures. While the annual composite gross returns changed by an immaterial amount for each year, the composite's net annual returns changed quite a bit, as this account was a non-fee-paying account. Does this qualify as an error?*

Firms must have written policies and procedures on how they handle prior period adjustments. Assuming the change in the composite's net annual returns is considered material – based on the firm's definition of materiality – the firm should treat this as the correction of an error and report the correction to those prospective clients that received the incorrect information.

Further, erroneous disclosure notes may also require the firm to consider republishing compliant presentations. The GIPS standards require firms to disclose whether non-fee-paying portfolios have been included in the composite and the percentage of composite assets that are non-fee-paying. Depending on whether the firm had other non-fee-paying portfolios in this composite, the firm would need to determine whether:

- the required GIPS disclosure was missing, which would result in a material error), or
- whether the disclosure was misstated which may or may not result in a material error.

***4. While undergoing our first verification, we noted that we had not consistently calculated asset weighted standard deviation for our internal risk measure. In two of the past 5 years we had calculated an equal weighted standard deviation. We intend to restate all amounts to reflect the asset weighted standard deviation. Does this qualify as an error?***

First, it is important to recognize the GIPS standards require firms to present “a measure of dispersion of individual component portfolio returns around the aggregate composite return.” The GIPS standards do not specify that firms use a specific measure of dispersion and leave the choice of which measure to present up to the firm.

Depending on the firm's policy for handling error correction, there are many potential solutions to the above situation, two of which are: (1) If the restatement of the two years to an asset-weighted standard deviation measure did not result in a material change, the firm should restate the dispersion information on the performance presentation; or (2) If the restatement results in a material correction, the firm should republish the presentation, making certain that ANY prospective client that the firm believes relied upon the incorrect information is updated with the correct information. A disclosure must also be provided to ensure that the prospective client fully understands the change.

***5. We recently determined that our list and description of composites inadvertently excluded 5 of our cash management composites. We have supplied this list to hundreds of prospective clients over the past few years. Does this qualify as an error?***

Firms must have written policies and procedures on how they handle prior period adjustments. In the situation described, the omission of five of the firm's composites from the required list and description of firm composites is considered an error; however, the firm must determine whether this is considered a material error and necessitates further action (such as republishing the list to all prospective clients that relied on the

incorrect information provided). The firm must evaluate their error correction policies and procedures to make a determination as to whether any further steps are necessary.

- 6. Our firm had a software problem that went unnoticed for several months. We recently became aware of the issue and have corrected our composite returns and updated our presentations. We have attempted to identify everyone who received an incorrect GIPS compliant presentation and have provided updated presentations to them. However, we believe there may be others that we are not aware of, and/or may have obtained our presentations on the website. How do we handle this?***

Given that the firm has deemed this error “material” according to their policies and has decided to republish the presentation for all prospective clients that relied on the information, the firm should consider taking additional steps to ensure that clients that relied on the erroneous information are informed. The firm should include a disclosure on all presentations that indicates the presentation has been changed due to an error on a specified date and that the information provided may differ from previous presentations. This disclosure should remain on the presentation a minimum of twelve months.