



Global Investment Performance Standards

GIPS® Guidance Statement on Performance Examinations

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www.gipsstandards.org

Guidance Statement on GIPS® Performance Examinations

Introduction

The scope and purpose of verification is to confirm that an investment management firm has complied with all the composite construction requirements of the Global Investment Performance Standards (GIPS) on a firm-wide basis and the firm's performance measurement processes and procedures are designed to calculate and present performance results in compliance with the GIPS standards (Standards) on a firm-wide basis. Verification does not confirm the appropriateness of a specific composite presentation.

Should an investment firm want to have confirmed the appropriateness of a specific composite presentation, the firm may choose to have a further, more extensive, specifically focused examination (or performance audit) of a specific composite and its presentation. The detailed review of any of the firm's composites by an independent third-party "verifier" is termed a performance examination. The performance examination may be performed concurrently with or upon completion of verification.

Performance examinations are currently neither recommended nor required under the Standards. Examinations of this type are also unlikely to become a requirement of the Standards or become mandatory; however, certain parts of the investment management industry require composite-specific performance examinations to provide them with additional and specific assurance that a particular composite has been independently examined with respect to the GIPS standards. The following guidance has been developed in order to ensure consistency of the procedures that are to be followed when a firm chooses to have a performance examination conducted on one or more of its composites.

Scope and Purpose of Performance Examination

1. A performance examination is the review of a specific composite by an independent third-party verifier. A performance examination tests, for a specific composite:
 - a. Whether the firm has constructed and calculated the composite in compliance with the GIPS standards, and
 - b. Whether the firm presents the composite in compliance with the GIPS standards.

A performance examination report is issued only with respect to a single composite examined by a verifier and does not attest to the accuracy of a performance presentation for any other composite.

2. A performance examination requires that:
 - a. The investment firm has a verification report(s) stating that the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and the firm's processes and procedures are designed to calculate and present performance results in compliance with the GIPS standards.

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- i. A principal verifier may accept the work of a local or previous verifier as part of the basis for satisfying that a firm has previously received a verification report. The verifier must use discretion when placing reliance on another verifier's verification report(s).
 - ii. It is expected that the time periods covered by a verification report(s) include the performance examination time period. Typically, the firm has a performance examination conducted concurrently with a verification and the time period covered by the performance examination is covered within this verification. In this instance, the performance examination report may not be issued prior to the verification report.
 - b. The verifier performs procedures to confirm that the specific composite has been constructed, calculated and presented in compliance with the GIPS standards.
3. The GIPS standards do not specify any particular format for the performance examination report issued by verifiers; however, a performance examination report generally includes the following information:
- a. The report is for a performance examination.
 - b. The name of the composite that was examined.
 - c. The time period covered by the report.
 - d. The verifier conducted the performance examination of the specified composite in accordance with the Guidance Statement on GIPS Performance Examinations.
 - e. The verifier's opinion that the composite was constructed, calculated and presented in compliance with the GIPS standards.

Without the performance examination report from the verifier, the firm cannot state that the composite has been examined with respect to the GIPS standards. The underlying composite presentation that is examined must be incorporated in the verifier's performance examination report (e.g., included in or attached to the report).

4. After completing the performance examination procedures, the verifier may conclude that the presentation does not satisfy the GIPS standards (e.g., the records of the firm cannot support the composite construction or calculation methodologies used). In such situations, 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. The verifier and the investment management firm must also consider the impact of the verifier's inability to provide the performance examination report on the firm's claim of compliance with the GIPS standards.

Fundamental Considerations for Performance Examinations

When conducting a performance examination of a specific composite, the verifier should consider the following presumptions, bearing in mind that they are not mutually exclusive and may be subject to important exceptions:

- Information obtained from independent sources outside the investment management firm provides greater assurance than information secured solely from within the investment management firm.

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- Information obtained from the verifier's direct personal knowledge (such as through tangible documentation, observation, computation, operating tests, or inspection) is more persuasive than information obtained indirectly.
- The more effective the controls over the subject matter, the more assurance they provide about the subject matter or the assertion.

The verifier's objective when conducting a performance examination is to accumulate sufficient evidence and perform appropriate procedures such that the risk of not detecting errors in the composite presentation during the performance examination is mitigated to an acceptably low level of risk.

The extent to which the performance examination procedures will be performed should be based on the verifier's consideration of:

- (a) the nature and materiality of the information to be tested,
- (b) the likelihood of misstatements,
- (c) knowledge obtained during current and previous engagements,
- (d) the extent to which the information is affected by judgment, and
- (e) inadequacies in the underlying data.

Required Performance Examination Procedures

The following are the minimum procedures required when conducting a performance examination. Verifiers must follow these procedures prior to issuing a performance examination report to the investment management firm.

Pre-Performance Examination Procedures (applicable if the performance examination is being conducted by a verifier that did not perform the firm-wide verification):

- **Knowledge of the Investment Management Firm:** Verifiers conducting the performance examination must obtain the relevant verification report(s) and the composite presentation(s) to be examined, as well as any other available information regarding the firm to ensure appropriate knowledge of the firm.
- **Knowledge of the GIPS standards:** Verifiers conducting the performance examination must understand all the requirements and recommendations of the GIPS standards, including any updates, reports, guidance statements, interpretations, and clarifications and must consider all such information (See GIPS Provision 0.A.15).
- **Knowledge of Applicable Country-Specific Laws and Regulations:** Verifiers conducting the performance examination must be knowledgeable of country-specific laws and regulations applicable to the firm and must determine any differences between the GIPS standards and the country-specific laws and regulations.
- **Knowledge of Investment Management Firm's Policies:** Verifiers conducting the performance examination must obtain the investment management firm's written policies and procedures used for the composite when establishing and maintaining compliance during the period to be examined.

Performance Examination Procedures:

- 1) **Sample Portfolio Selection:** Objective: to ensure the proper portfolios are included in the examined composite. Verifiers conducting the performance examination may check compliance with the GIPS standards using a selected sample of the composite's portfolios.
 - a) Obtain a list of open and closed portfolios for the composite for the period under examination and ensure composite inclusion policies and procedures were appropriately implemented;
 - b) Ensure the composite includes all actual, fee-paying discretionary portfolios that meet the definition of the composite for the period under examination; and
 - c) Consider the following criteria when selecting the sample portfolios for examination:
 - number of portfolios in the composite,
 - definition of the composite,
 - total assets of individual portfolios relative to total composite assets,
 - internal control structure at the firm,
 - number of years under examination, and
 - use of technology and external service providers.

- 2) **Cash Flows:** Objective: to determine whether capital contributions and withdrawals:
 - a) are recorded in the proper portfolios,
 - b) at the correct amounts, and
 - c) on a timely basis, consistent with the established policies.

Procedures should be considered and performed at a level such that the verifier is satisfied that:

- cash flows reflect appropriate supporting documentation, such as custody statements or internal records,
- contributions or withdrawals of securities reflect proper valuation and timely recording, and
- the methods used to account for cash flows, contributions, and withdrawals are appropriate and consistently applied.

- 3) **Income and Expenses:** Objective: to determine that income and expenses are:
 - a) recorded in the proper portfolios,
 - b) at the correct amounts, and
 - c) on a timely basis.

Procedures should be considered and performed at a level such that the verifier is satisfied that:

- income and expenses reflect supporting documentation such as custody statements or internal records,
- the methods used to record income and expenses, including investment management fees, are consistently applied and appropriate relative to the calculation of net- and/or gross-of-fees performance returns, and
- the calculation and use of accrued income is reasonable and appropriate.

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- 4) Portfolio Trade Processing: Objective: to determine that purchases and sales of securities have been:
- recorded in the proper portfolios,
 - at the correct amounts, and
 - on the appropriate dates.

Procedures should be considered and performed at a level such that the verifier is satisfied that:

- portfolio trading activity is supported by documentation such as custody statements or internal records,
- beginning- and end-of-performance measurement period portfolio positions are supported by documentation such as custody statements or internal records, and
- the methods used to account for portfolio trading activity are appropriate and consistently applied.

- 5) Portfolio Valuation: Objective: to determine whether the beginning- and end-of-performance measurement period valuations of security positions are:
- valued correctly, and
 - valued on the correct dates.

Procedures should be considered and performed at a level such that the verifier is satisfied that:

- beginning- and end-of-performance measurement period security valuations are consistent with the firm's valuation policies,
- foreign currency exchange rates used are consistent with the firm's valuation policies, and
- the methods used for portfolio valuation are appropriate and consistently applied.

- 6) Performance Measurement Calculation: Objective: to determine that portfolio and composite returns have been correctly calculated.

Procedures should be considered and performed at a level such that the verifier is satisfied that:

- computations of portfolio returns are appropriate and consistently applied
- computations of the composite's returns are appropriate and consistently applied.

- 7) Composite Presentation Information and Disclosures: Objective: to determine whether the presentation includes all the information and disclosures required by the GIPS standards, such that the information and disclosures:
- have been properly presented in the examined composite's performance presentation and
 - are appropriately supported by available documentation.

This objective is also applicable to additional information (i.e., recommended disclosure and presentation items) if it is included in the examined composite's performance presentation.

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Procedures should be considered and performed at a level such that the verifier is satisfied that:

- all of the required disclosure and presentation and reporting provisions have been adequately satisfied,
 - required calculations have been performed appropriately, and
 - the application and inclusion of the disclosure and presentation and reporting provisions are appropriate and reasonable.
- 8) Maintenance of Records: The verifier must maintain sufficient information to support the performance examination report.

Prior to issuing the performance examination report, the verifier conducting the performance examination must obtain a representation letter from the investment management firm confirming that the composite being examined has been constructed and calculated and its presentation has been prepared and presented in compliance with the GIPS standards. The management representation letter should also confirm any other specific representations made to the verifier during the examination.

Effective Date

All investment management and verification firms that choose to engage in a performance examination of a specific composite that covers performance results for periods ended 31 December 2006 or thereafter must apply this guidance. Early adoption of this guidance is encouraged. This guidance should be considered industry global best practice. Firms are not required to have a composite presentation reexamined using this guidance if a performance examination was completed on a composite presentation that reported performance results prior to 31 December 2006, i.e., retroactive application of this guidance is not required.

Applications:

1. *Our firm recently completed our annual verification process and then hired a different verification firm to conduct performance examinations on a few selected composites. During the verification, several issues were identified that might be important for the performance examination verifier to know. What is the investment management firm's responsibility to report such information?*

It is the responsibility of the investment management firm to fully disclose any information that might impact the work of the verifier who is performing the performance examination(s). Although permitted by the GIPS standards, it is not required that the verifier conducting the performance examinations accept the work of another verifier as part of the basis of the opinion for the performance examinations. Investment management firms should consider the impact of having different verifiers perform the verification and the performance examination(s).

2. *We are a verification firm and have been hired to conduct a verification for ABC Asset Management Firm. In addition to the verification, we have also been hired*

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to conduct a performance examination on the ABC Large Cap Composite. What language must be included in our performance examination report?

The GIPS standards do not specify any particular format for the performance examination report issued by verifiers. There are several options for the language that can be included in a performance examination report. When the same verifier performs both the verification and performance examination, a commonly used template makes reference to both. The verification firm could consider using the language provided in the following sample report, and should also add references to any professional standards to which the verifier might be held.

<p>ABC Asset Management Firm ABC Address</p> <p>Re: Verification of ABC Asset Management Firm and Performance Examination of ABC's Large Cap Composite</p> <p>This verification has been performed for the period from 1 January 2000 to 31 December 2006 for ABC Asset Management Firm Inc. (the investment management subsidiary of QRS Bank), and confirms that in our opinion:</p> <ul style="list-style-type: none">• the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis, and• the firm's processes and procedures are designed to calculate and present performance results in compliance with the GIPS standards. <p>Also, in our opinion:</p> <ul style="list-style-type: none">• for the period from 1 January 2000 through 31 December 2006, the firm has constructed and calculated its Large Cap Composite in compliance with the GIPS standards, and• the accompanying presentation of the Large Cap Composite is in compliance with the GIPS standards. <p>We conducted this verification in accordance with the verification procedures set forth in the GIPS standards and performed this performance examination in accordance with the performance examination procedures set forth in the Guidance Statement on GIPS Performance Examinations.</p>
<p>ABC Asset Management Firm's management is responsible for compliance with the GIPS standards, the design of its processes and procedures, and for ABC's Large Cap Composite presentation. Our responsibility is to express an opinion based on our verification and performance examination.</p> <p>This report does not attest to the accuracy of any composite presentation of ABC Asset Management Firm other than the firm's Large Cap Composite.</p> <p>_____ (signature)</p> <p>XYZ Verification Company 15 March 2007</p>

3. How does a performance examination differ from a verification?

The purpose and scope of verification is to confirm that the firm has complied with all the composite construction requirements of the Standards on a firm-wide basis and the firm's performance measurement processes and procedures are designed to calculate and present performance results in compliance with the Standards on a firm-wide basis. Verification is not to be seen as an attempt to confirm the appropriateness of a specific composite presentation. Verification ensures the policies and procedures used to establish and maintain compliance with all the applicable requirements of the GIPS standards are in place and, on a sample basis, tests whether or not the processes and procedures used to implement those policies are in place.

A performance examination tests whether a specific composite has been constructed, calculated, and presented in compliance with the Standards. A performance examination includes testing on a specific composite to ensure the firm has implemented its processes and procedures to comply with the composite construction, calculation and presentation requirements of the GIPS standards for a specific composite.

For example, when conducting a verification, the verifier must determine the firm's policy with regard to the accrual of interest income. The verifier should perform testing for a selected sample of portfolios on a firm-wide basis to determine whether the firm's policies and assumptions with respect to the accrual of interest income is reflected in the calculation of returns. The selected sample of portfolios may or may not include portfolios from all of the firm's composites.

When a performance examination is conducted for a specific composite, a sample of portfolios in the specified composite is selected and the verifier must determine whether the firm has properly implemented the firm's policy, i.e., income is recorded in the proper portfolio, at the right amount and on a timely basis.

4. The performance examination procedures state that compliance with the Standards may be checked using a selected sample of the composite's portfolios. Is there any guidance on what the size of the sample must be to ensure the accuracy of the performance examination?

The size of the sample of portfolios selected from the composite will vary based on the verifier's judgment when considering the criteria listed in Procedure 1.c of the Guidance Statement on GIPS Performance Examinations. It should be noted that the process of using a selected sample of portfolios is similar to that used in the verification procedures when selecting a sample of the investment firm's portfolios to check compliance with the GIPS standards.

It is not possible to give a specific number of portfolios or a percentage of portfolios that must be checked per composite. As provided in the Guidance Statement on GIPS Performance Examinations, the verifier's objective is to accumulate sufficient evidence and perform appropriate procedures such that the risk of not detecting errors in the composite presentation during the examination is mitigated to an acceptably low level of

risk.

Not only must the verifier determine the appropriate sample size, but the verifier must also determine if the sample selected is reasonable considering the firm's specific circumstances. For example, when testing security prices the verifier may determine that testing market values for securities listed on exchanges is relatively straightforward and minimal testing is needed; however, for thinly traded securities, the verifier may determine that additional testing is needed. The verifier must determine what procedures will be performed to determine that the portfolio valuation methodologies are reasonable.

5. Our most recent firm-wide verification report and performance examination for the Large Cap Composite covered the period from 1 January 2000 through 31 December 2005. We received a Request For Proposal (RFP) asking for our Large Cap Composite performance results from 1 January 2000 through 30 June 2006. The RFP asked whether the Large Cap composite had been independently examined with respect to the GIPS standards. Because we want to be able to say that the composite presentation has been examined for all periods being requested (through 30 June 2006), we would like to have a performance examination completed through 30 June 2006. Must the firm-wide verification report be updated through 30 June 2006 before a performance examination can be completed for the Large Cap Composite for the same time period?

It would be expected that the periods covered by a verification report would be consistent with the period(s) covered by the performance examination. The firm's best option would be to have both the verification and performance examination updated to cover the requested period, in this instance through 30 June 2006. However, recognizing that there may be limitations to the immediate availability of a verification firm to perform a full verification for the six-month period, there may be unusual and infrequent situations where a performance examination could cover longer periods than the verification. Both the investment management firm and the verifier performing the performance examination would need to consider the firm's policies and procedures, including the controls surrounding the application of those policies and procedures to the longer period.

If the verifier concludes that they can issue a performance examination report for the period beyond the verification, it should not exceed twelve (12) months beyond the date of the most recent verification report. In the interest of fair representation and full disclosure, both the performance examination report and the composite presentation accompanying the RFP should clearly disclose: (a) the lack of a verification for the specified time period and (b) that the document can only be provided to the prospective client making the request.