



## More Highlights from the 2010 edition of the GIPS Standards

On January 29, 2010, the GIPS Executive Committee approved the 2010 edition of the GIPS® standards. In our January 2010 newsletter we reviewed highlights of the key changes in the main body of the GIPS standards (sections 0-5). In this newsletter we review changes in the verification section.

The verification section is guidance that verifiers must follow when conducting a verification. Normally we would not review these detailed changes, as the guidance is not directed to firms that comply with the Standards. However, because a firm will be required to disclose whether or not the firm has been verified, we expect more focus on the entire verification process, as well as what verification is and what it is not.

There has been a great deal of misunderstanding surrounding what exactly verification tests, and what level of assurance is provided by a verification. Verification does not “verify” a firm’s claim of compliance with the GIPS standards or provide an opinion on whether a firm is properly claiming compliance with the GIPS standards. Verification also does not “verify” returns of a specific composite. To address this issue and help clarify what verification is, and is not, the new claim of compliance for a verified firm explains the scope of verification. The complete claim of compliance for a verified firm is as follows:

“[Insert name of firm] claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. [Insert name of firm] has been independently verified for the periods [insert dates.] The verification report(s) is/are available upon request.

Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm’s policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation. “

The verification guidance itself was extensively enhanced. The updating process was happening when the Ponzi schemes were in the news. Some of the firms that were found to be Ponzi schemes claimed compliance

with the GIPS standards, and were verified. As you might imagine, this did not sit well with the GIPS Executive Committee and others involved in updating the Standards. While a verification is not intended to detect fraud, just as a financial statement audit is not intended to detect fraud, the language in the verification guidance was strengthened to explicitly describe the minimum testing procedures that must be conducted during a verification. Many verification firms, including our firm, would say that the new guidance has now caught up to the work that we have been doing all along and that the current guidance did not adequately explain the tests that must be performed in order for a verification firm to conclude that it is proper to issue a verification report. But why is the verification guidance language so important? First, a firm that is being verified should understand what work a verifier should be doing when conducting a verification. A firm that is knowledgeable about the verification requirements will be better able to determine if the verifier is thorough, and if they are getting the level of service they should expect. Also, there are no “verification police” keeping out the bad verifiers. Any person or firm can declare themselves a qualified verifier. (Just this week we were asked to review a draft “performance report” provided to a firm for their approval. This draft report had a date in April 2010. The verifier’s report said they conducted a Level II AIMR verification. We kid you not.) Enhancing the language should hopefully raise the bar and increase the quality of verifications provided by firms that need a bit more guidance. Highlights from the verification guidance follow.

**“Must” is a defined term.** The verification language itself was strengthened. The word “must” is used throughout this section. (“Must” is defined in the glossary as a provision, task, or action that is mandatory or required to be followed or performed.) The use of “must” throughout should eliminate any questions as to whether or not a verifier is required to perform a step included in the verification guidance.

**Verifiers must perform testing to reach a conclusion.** In almost each step that is listed, it now states that a verifier “must perform sufficient procedures to de-

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termine that...” This language is much stronger than the current guidance. For example, current guidance says, “Verifiers must be satisfied that the firm’s definition of discretion has been consistently applied over time.” How exactly does a verifier become satisfied? Through discussion? Through osmosis? Now a verifier “Must perform sufficient procedures to determine that the firm’s definition of discretion has been consistently applied over time.”

**Placing reliance on work performed by a third party.** A verifier may choose to place reliance on work that is done by another party. This is often done so as to not replicate work that has already been done. A common example would be placing reliance on the information that is included in the audited financial statements of a mutual fund. If a verifier plans to place reliance on work of a third party, the verifier must document all reliance considerations, including the qualifications, competency, objectivity and reputation of the third party. This requirement should hopefully prevent a verifier from placing reliance on work performed by a three person CPA firm working out of an office in a strip mall.

**Verifiers must subject the entire firm to testing.** The verification report is issued to a firm, which must be in compliance with the GIPS standards on a firm-wide basis. Therefore, the entire firm must be tested, and not just the “marketed” strategies or departments. If your verifier has not subjected your non-marketed composites to testing before, this explicit statement should be a wake-up call and they should be doing proper firm-wide testing from now on.

**Verifiers must gain an understanding of the firm, including the corporate structure of the firm and how it operates.** This is a new requirement that expands the current requirement for a verifier to determine that the firm is, and has been, appropriately defined. This new requirement goes hand in hand with the requirement for the verifier to conduct proper firm-wide testing. Unless the verifier fully understands the firm definition, they will not be able to identify and test all assets within the firm definition.

**The verifier must obtain a copy of the firm’s policies and procedures used in establishing and maintaining compliance with the GIPS standards and ensure that all applicable policies and procedures are properly included and adequately documented.** This makes it

explicitly clear that the firm must provide the policies and procedures to the verifier. (We’ll refer to this as the firm’s GIPS Manual). Also, the verifier cannot prepare the GIPS Manual for the firm. While the verifier may provide guidance to a firm to help them create their GIPS Manual the verifier cannot be primarily responsible for creating the GIPS Manual. If the verifier provides a “shell” policy manual where all the firm has to do is find [insert firm name] and replace with the firm’s name, this would not be in line with the intent of this requirement. It is clearly the firm’s responsibility to document their policies and procedures, not the verifier’s. Also note that the GIPS Manual must include both policies and procedures. Quite often we see firms that have documented their policies, but none of their procedures. Procedures are the steps the firm takes to ensure the firm complies with their established policy. For example, assume a firm’s policy is to include new accounts in composites after the first full month under management. The firm should have a series of procedures to ensure this policy is followed, such as:

- How the performance department is notified of new accounts at the firm;
- How the new account’s composite assignment is determined and communicated to the performance department, so the account is included in the correct composite; and
- How new account funding information is provided to the performance department, to ensure the timing of composite inclusion is proper.

When you are taking a fresh look at your GIPS Manual, keep in mind revised Provision 4.A.12, which requires a firm to disclose that policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request. Note that a firm must provide policies only, not policies and procedures. This expanded requirement will effectively require a firm to provide all of the policies the firm follows when maintaining compliance with the GIPS standards, if requested.

**The verifier must ensure that all applicable policies and procedures are included in the GIPS Manual.** Consider Provision 0.A.5, which requires a firm to document their policies and procedures used in establishing and maintaining compliance with the GIPS standards. Given that the firm must document all of the policies and procedures related to complying with the GIPS standards, the verifier will test to en-

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sure that all the policies and procedures are in fact properly documented. Note that there is no requirement for all of the firm's policies and procedures related to GIPS compliance to be included in one stand-alone document. Many of the procedures related to GIPS compliance may properly be found in other policies and procedures of the firm, as these policies and procedures would exist even if the firm did not comply with the GIPS standards (e.g. valuation procedures). A firm could duplicate this information in their GIPS Manual, or could simply make reference to the location of procedures that are maintained elsewhere. We find that larger firms will typically have more references to other locations where detailed procedures are maintained.

**Verifiers must perform sufficient procedures to determine that the firm's policies and procedures for ensuring the existence and ownership of client assets are appropriate and have been consistently applied.** Revised Provision O.A.5 requires a firm to document their policies and procedures, including ensuring the existence and ownership of assets. The change to require a firm to have policies and procedures in place to ensure that client assets are properly stated is simply a change to explicitly state what has been an implicit requirement all along. After all, how can a firm properly value a portfolio if they don't know how many shares of each security they hold? As long as a firm has been properly reconciling to custodian positions, and they have comparable controls in place for accounts that do not have a custodian (such as limited partnership interests) a firm should not have to make any changes in their policies and procedures. The firm should make sure they have procedures relating to this area properly documented. If your verifier has not previously tested your custodian reconciliation process, you should expect them to start doing so.

**Testing of discretionary status of portfolios.** Verifiers must obtain a listing of all firm portfolios and make selections from this list to test discretionary status. Current guidance says that a verifier must perform testing, on a sampling basis, to determine if portfolios are properly classified as discretionary or non-discretionary. Now it is made clear that the sample must be taken from the firm's list of all portfolios within the firm. Of course the verifier will first perform testing on this list to make sure it is in fact complete and includes all portfolios within the firm. For those firms that are SEC

registrants, be prepared to provide a reconciliation of this report to Form ADV AUM and number of portfolios.

**Testing allocation of portfolios to composites.** Verifiers must obtain lists of all open (new and existing) and closed portfolios for all composites and make selections from these lists to test composite inclusion/exclusion. Current guidance says the verifier must obtain a listing of open and closed accounts for all composites, and select a sample from these lists, to test proper inclusion in and exclusion from composites. The current guidance clarifies that "open" portfolios includes both new and existing accounts. The verifier should not be testing only portfolios that open or close during the period being verified.

**Testing completeness of composites.** Verifiers must perform sufficient procedures to determine that a composite includes only portfolios that belong in the composite, as well as determine that all portfolios that should be in a composite are in fact included in a composite. This concept is often referred to as "full inclusion" testing. From a verifier's perspective, it is easy to test the composite information that is provided by the firm. It is much more challenging to determine how to identify portfolios that should be included in a composite and are not. If your verifier has not dug deep into your excluded account list and your ADV AUM reconciliation, they will now.

**Verifiers must test the calculation of firm assets.** This is a new requirement. While most verifiers surely tested firm assets, verifiers now have an explicit requirement to do so. Once again your ADV AUM reconciliation should be requested and will be tested.

**Take a sample of composite and benchmark calculations, to test the accuracy of all required numerical data included in the compliant presentation, such as standard deviation or internal dispersion.** No testing of benchmark information was previously required. Nor was testing of internal standard deviation, or number of accounts. A verifier simply had to test that the information was included. Again, we know that most verifiers have been testing the calculation of this information all along.

**Test custom benchmark calculations.** The current edition of the Standards is silent on this topic. Now a verifier must test the actual calculation of the custom benchmark.

*"Verifiers must perform sufficient procedures to determine that the firm's policies and procedures for ensuring the existence and ownership of client assets are appropriate and have been consistently applied."*

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Be ready to provide the returns of the component benchmarks to the verifier.

**Missing or incomplete documents or the presence of errors would normally be expected to warrant selecting a larger sample or applying additional verification procedures.** Verification is testing of a firm's policies and procedures. It is not a replication or recreation of a firm's entire composite construction and calculation processes. The results of the testing of the selected sample tell the verifier whether the firm is properly following its procedures. If the testing results are good, then the verifier may conclude, based on the sample results, that the firm is following the policies and procedures for all accounts, and not just the sample. If the results of the sample are poor, then the verifier will conclude that the firm is not following its procedures, and will need

to select additional items to test, to determine if the first sample was not representative of the total population. Of course the verifier could conclude that the firm is not in compliance and would stop there. It is a matter of professional judgment whether the verifier should simply do more testing, or should just stop the engagement.

**A verifier must not issue a verification report if they know the firm is not in compliance.** While this seems obvious, it is driving home the point that the verifier cannot turn a blind eye to signs or proof that a firm is not in compliance, even if the issue falls outside the period that is being subject to verification.

So what should a firm expect from their next verification? Probably more questions, more selections, and more testing. Be prepared!

## Mark your Calendar: Annual GIPS Conference in San Francisco

The 2010 annual GIPS conference, sponsored by CFA Institute, will be at the Westin Market Street Hotel in San Francisco on September 29-30, 2010. The GIPS Standards workshop will also be offered the day before the conference, on September 28, 2010. Note that these events are from Tuesday-

Thursday, which is a departure from the norm. Preliminary information about these events is available on the [GIPS standards website](http://www.gipsstandards.com).

Most years the conference and the workshop sell out, so if you plan to attend make sure you register early.