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1995

NOTICE TO PRACTITIONERS: Examination Engagements to Report on Investment Performance Statistics Based on Established or Stated Criteria

American Institute of Certified Public Accountants. Investment Companies Committee

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American Institute of Certified Public Accountants. Investment Companies Committee, "NOTICE TO PRACTITIONERS: Examination Engagements to Report on Investment Performance Statistics Based on Established or Stated Criteria" (1995). *Guides, Handbooks and Manuals*. 444.
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NOVEMBER 1995

INVESTMENT COMPANIES COMMITTEE
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS**NOTICE TO PRACTITIONERS**Examination Engagements to Report on Investment Performance
Statistics Based on Established or Stated Criteria**Introduction**

It has come to the attention of the AICPA's Investment Companies Committee that practice is diverse concerning the reporting on examinations of investment performance statistics. This Notice to Practitioners will address this diversity and will amend the guidance provided in a previous Notice to Practitioners, "Engagements to Report on Performance Presentation Standards of the Association for Investment Management and Research," issued by the Auditing Standards Division of the AICPA (Call 1-212/596-6036 to request a copy). It provides practical applications of the reporting example included in paragraph 54 of Statement on Standards for Attestation Engagements (SSAE) No. 1, *Attestation Standards* (AICPA, *Professional Standards*, vol. 1, AT sec. 100).

Background

The asset-management services industry is composed of a diverse group of financial entities, including: registered investment companies, investment partnerships (such as venture capital funds and hedge funds), registered investment advisors, commodity pool operators and trading advisors, commercial and investment banks, and trust companies. Despite the diversity in these entities' financial structures and regulatory environments, a common goal of these entities is the maximization of rates of return, within a given set of risk parameters, on money being managed. A presentation of a financial entity's past performance in managing proprietary or client funds can be a powerful tool for the asset-management firm in attracting new clients and maintaining its client base.

Expanded competition in the asset-management industry, combined with a growing divergence in the presentation of investment performance statistics by investment managers and advisors over the last five years, has resulted in an increased focus on these types of presentations. This focus has been generated both internally within the asset management industry (The Association for Investment Management and Research [AIMR]) as well as externally by the applicable regulators (The Securities and Exchange Commission [SEC], The National Futures Association [NFA], and The Commodity Futures Trading Commission [CFTC]). As a result of these internal and external pressures, the following standards for which money managers present various performance statistics have emerged in the industry:

- a. *The Performance Presentation Standards, 1993, With Commentary and Interpretation*, issued by the AIMR (call 1-804/977-6600 to request a copy) - The AIMR and its subsidiary organizations, the Financial Analysts Federation (FAF) and the Institution of Chartered Financial Analysts (ICTA), issued the Performance Presentation Standards in March 1993 as a set of guiding principles intended to promote full disclosure and fair representation by investment managers in reporting their investment results. The standards also attempt to ensure uniformity in reporting, so that results are directly comparable among investment managers. The Performance Presentation Standards dictate minimum mandatory calculation requirements and disclosures and also recommend guidelines and disclosures. The Performance Presentation Standards generally have been applied to traditional products, such as equity and debt securities; however, the standards can also be applied across a broad range of securities, including derivative products.

- b. **CFTC Rule Regulations 4.21(a) and 4.31(a)** - These regulations provide guidance for Commodity Pool Operators (CPOs) and Commodity Trading Advisors (CTAs) when disclosing past investment performance statistics to current and potential clients.
- c. **The Total Return Calculation as defined by the SEC** - The SEC requires the disclosure of a registered investment company's total rate of return within the company's financial highlights that are filed with the SEC. This rate of return represents the annual rate of return the individual investment company earned during the respective years presented. The total return calculation as defined by the SEC is not intended to indicate a money management firm's ability to manage money in accordance with a particular investment style. Rather, the calculation represents the return earned by a separate investment company, relying on the legal structure of the company as the basis for the presentation as opposed to the trading or investment strategy.
- d. **Other** - Money managers present results in accordance with the measurement and disclosure criteria established by the Investment Counsel Association of America (ICAA) as well as by using hybrid methods of the aforementioned presentations.

In August 1993, the Auditing Standards Division issued the Notice to Practitioners, "Engagements to Report on Performance Presentation Standards of the Association for Investment Management and Research," which provided guidance to accountants on performance and reporting for presentations in compliance with the AIMR *Performance Presentation Standards*. The previous Notice to Practitioners did not address attestation reports presented in compliance with other established criteria as defined by SSAE No. 1. This Notice to Practitioners amends the previous Notice to Practitioners and provides guidance on accountants' attestation reports for all presentations of investment performance statistics in compliance with established criteria. This Notice is not intended to provide guidance on the practitioners' performance of these attestation engagements.

Relevant Guidance

SSAE No. 1 provides specific performance and reporting guidance that practitioners should follow when examining investment performance statistics. In applying SSAE No. 1 to presentations of investment performance statistics, practitioners should consider the matters discussed in the following paragraphs.

The Third General Standard of SSAE No. 1, *Attestation Standards* is

The practitioner shall perform an engagement only if he or she has reason to believe that the following two conditions exist:

- a. The assertion is capable of evaluation against reasonable criteria that either have been established by a recognized body or are stated in the presentation of the assertion in a sufficiently clear and comprehensive manner for a knowledgeable reader to be able to understand them.
- b. The assertion is capable of reasonably consistent estimation or measurement using such criteria.

The AIMR's *Performance Presentation Standards*, the CFTC's regulations 4.21(a) and 4.31(a), and the total return calculation as defined by the SEC meet the established criteria definition because of their acceptance in their respective industries and their issuance by professional and governmental bodies.

In circumstances in which a practitioner receives a request from a client to perform the engagement in

accordance with nonestablished criteria, the practitioner should thoroughly understand the reasons for the request and whether the resulting presentation could mislead users of the report. If the practitioner accepts an engagement involving the use of nonestablished criteria, the criteria should be stated in the presentation of the assertion in a sufficiently clear and comprehensive manner for knowledgeable readers to be able to understand the criteria for a general distribution report to be issued. However, if the practitioner accepts an engagement involving the use of nonestablished criteria and the criteria are not sufficiently clear and comprehensive, the practitioner may issue a report with restricted distribution.

AIMR Level I Verification Reporting

The AIMR provides for two levels of verification for AIMR presentations. The verifications are typically performed by independent public accountants. Level I verification attests to the assertion that all of the firm's actual, discretionary, fee-paying portfolios are included in at least one composite. Level II verification attests to assertions regarding both the investment management process (tests of validity and propriety of underlying shares, income, and pricing data) and the measurement of performance (computation and presentation of performance data). Level II verification includes attesting to the Level I assertion. However, companies generally attach the Rates of Return schedules to the practitioner's report in either case.

Paragraph 3 of SSAE No. 1 states that "the practitioner who does not explicitly express a conclusion about the reliability of an assertion that is the responsibility of another party should be aware that there may be circumstances in which such a conclusion could be reasonably inferred." Because the Rates of Return schedules are normally attached to the practitioner's report in a Level I verification, readers may erroneously conclude that the practitioner has examined them. Therefore, the practitioner should indicate his or her association with the Rates of Return schedule and communicate the limited nature of the engagement. Whenever the practitioner is reporting on a Level I examination, but has not performed a Level II examination, the practitioner's report should include the following paragraph (see exhibit G for a sample report):

We have not been engaged and did not examine the validity and calculation of the Rates of Return of XYZ Capital Management, Inc. for the annual and compounded investment periods from January 1, 1986, through December 31, 1995, and, accordingly, do not express an opinion thereon.

The practitioner should also request that the Rates of Return schedules be marked as "Not Examined by Independent Accountants." If the client does not comply, the practitioner should advise the client that he or she has not consented to the use of his or her name and should consider what other actions might be appropriate. In considering what actions, if any, may be appropriate in the circumstances, the practitioner may wish to consult his or her legal counsel.

Examination Reports

When issuing examination reports on investment performance statistics, the report should identify the assertion being reported on (for example, the schedule of rates of return) and state the character of the engagement as well as the practitioner's conclusion about whether the assertion is presented in conformity with the established criteria against which it was measured.

Paragraph 54 of SSAE No. 1 provides an illustration of an examination report. The examination reports included within this Notice to Practitioners are consistent with that example, with two exceptions. The examination reports included within this Notice to Practitioners include statements defining the responsibility the practitioner is assuming on the schedule of rates of return as well as a reference to materiality in the practitioner's opinion. The responsibility statements are included to prevent

misinterpretation of the degree of responsibility the practitioner is assuming when associated with the schedule of rates of return. In addition, the concept of materiality is well recognized in the second standard of reporting in the attestation standards and is a necessary element in conducting and reporting on an examination engagement.

Because of diversity in practice, sample practitioner reports are provided here as guidelines for independent public accountants when performing examination engagements on investment performance statistics.

- b Public Accountant Is Engaged to Examine All Years in a Presentation in Compliance With Established Criteria --** The AIMR requires that investment performance presentations be in accordance with the *AIMR Performance Presentation Standards* as of January 1, 1993. For periods prior to January 1, 1993, a firm has the option of restating historical performance numbers in accordance with the standards. Further, the standards require presentation of at least a ten year performance record (or for the period since firm inception, if shorter). The CFIC regulations require a minimum period of three years (there are currently plans to increase the minimum period to five years). The SEC requires a five-year period of performance. Exhibit A is a sample standard unqualified examination opinion, presented in accordance with the established criteria to be used when an accountant is engaged to examine all years of investment performance statistics.
- b Public Accountant is Engaged to Examine Only One Year in Multiple-Year Presentation in Compliance With Established Criteria --** It is not uncommon for asset-management companies to request the accountant to examine the most current annual investment performance statistics while presenting investment performance statistics that include all required years presented. To avoid any implication that the accountant has examined the preceding years, the accountant's report should be modified to include a paragraph stating that the accountant was not engaged to examine, and did not examine, the preceding years, and should disclaim an opinion on those years. In addition, the prior-period investment statistics that have not been examined should be clearly designated as "Not Examined by Independent Accountants." A sample report is included in Exhibit B.
- b Public Accountant Is Engaged to Examine Only One Year in a One-Year Presentation --** Situations have arisen in which the public accountant is engaged to examine only one year in a one-year presentation. As already discussed, the AIMR requires ten years of historical performance statistics, if applicable; the CFIC requires three years; and the SEC requires five years.

The applicable established criteria were intended to include both calculation *and* presentation standards. Even though a performance presentation for any one year complies with specific calculation standards, if it does not include all required disclosures or does not cover the required periods, the presentation does not conform to the established criteria and the practitioner's report should be modified. The established criteria *require* a minimum number of years in the presentation, when applicable, and the practitioner's report should be modified when a presentation is prepared that does not meet the established criteria. A sample report is included in Exhibit C.

- b Public Accountant Is Engaged to Examine All Years in a Ten-Year Presentation, With the Current Year in Compliance With AIMR Standards and the Preceding Years Presented in Accordance With Other Criteria --** The AIMR does not require retroactive restatement of prior periods in order to comply with the *AIMR Performance Presentation Standards*. As a result, it is common for investment managers to present ten years of information, with 1993 and subsequent years presented in conformity with the *AIMR Performance Presentation Standards* and the preceding years conforming to non-AIMR criteria described in the notes.

The overall presentation conforms to the AIMR *Performance Presentation Standards* because the current-year calculation complies and the overall presentation is complete. However, the individual preceding years are not in compliance. The practitioner's report should indicate which years presented conform to the AIMR *Performance Presentation Standards* and which years do not conform. In addition, for years that do not conform, the accountant's report should contain a statement indicating that presentations for those years were not intended to, and do not, conform to the AIMR Standards. A sample report is included in Exhibit D.

- b **Public Accountant Is Engaged to Examine All Years in a Ten Year Presentation, With an Exception** – Practitioners may encounter situations in which presentations of investment performance statistics are not in full compliance with the established criteria and contain exceptions. A sample report is included in Exhibit E.

- b **Reporting Issues When Significant Estimates Are Used** -- The practitioner's report should include an explanatory paragraph when the investment performance statistics on portfolios include securities whose values were estimated by the investment manager in the absence of readily ascertainable market values, and the range of possible values of those securities are significant. This report should be used only if the practitioner concludes that, after examining the underlying documentation supporting the investment manager's good-faith estimate of value, the valuation principles are acceptable, are being consistently applied, and are reasonably supported by the documentation. A sample report is included in Exhibit F.

Exhibit A

Sample Report for a Public Accountant Engaged to Examine All Years in a Presentation in Compliance With Established Criteria¹

Report of Independent Public Accountants

To XYZ Capital Management, Inc.:

We have examined the accompanying schedule of Rates of Return for the *[list the descriptions of the composites to be examined]* of XYZ Capital Management, Inc. (the "Company") for the annual and compounded investment periods from January 1, 1986, through December 31, 1995. This schedule is the responsibility of the Company's management. Our responsibility is to express an opinion on this schedule based on our examination. Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary in the circumstances.

In our opinion, the schedule of Rates of Return of XYZ Capital Management, Inc. for the above-stated investment periods is fairly stated, in all material respects, in conformity with *[list the established criteria that is the basis for the presentation]*.

[Signature]

[Location]

[Date]

¹This sample report assumes the presentation includes ten years of historical data. This sample would also be applicable if the presentation included a shorter period of time provided it was since inception of the firm or composite or met the minimum time period requirements of the applicable established criteria.

Exhibit B

Sample Report for a Public Accountant Engaged to Examine Only One Year in a Multiple-Year Presentation in Compliance With Established Criteria²

Report of Independent Public Accountants

To XYZ Capital Management, Inc.:

We have examined the accompanying schedule of Rates of Return for the *[list the descriptions of the composites to be examined]* of XYZ Capital Management, Inc. (the "Company") for the annual investment period from January 1, 1995 through December 31, 1995. This schedule is the responsibility of the Company's management. Our responsibility is to express an opinion on this schedule based on our examination. Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary in the circumstances.

In our opinion, the schedule of Rates of Return of XYZ Capital Management, Inc. for the above-stated investment period is fairly stated, in all material respects, in conformity with *[list the established criteria that form the basis for the presentation]*.

We were not engaged to examine, and we did not examine, the accompanying Schedule of Rates of Return *[list the descriptions of the composites to be examined]* for the annual and compounded investment periods from January 1, 1986, through December 31, 1994 and, accordingly, do not express an opinion thereon.

[Signature]

[Location]

[Date]

²This sample report assumes the presentation includes ten years of historical data. This sample would also be applicable if the presentation included a shorter period of time (more than one year) provided it was since inception of the firm or composite or met the minimum time period requirements of the applicable established criteria.

Exhibit C

Sample Report for a Public Accountant Engaged to Examine Only One Year in a One-Year Presentation

Report of Independent Public Accountants

To XYZ Capital Management, Inc.:

We have examined the accompanying schedule of Rates of Return for the *[list the descriptions of the composites to be examined]* of XYZ Capital Management, Inc. (the "Company") for the annual investment period from January 1, 1995, through December 31, 1995. This schedule is the responsibility of the Company's management. Our responsibility is to express an opinion on this schedule based on our examination. Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary in the circumstances.

[List the established criteria that form the basis for the presentation] require the presentation of *[list the number of years required by the established criteria]* years of performance statistics. As more fully discussed in Note X to the schedule of rates of return, the investment performance statistics include only the performance results for the investment period from January 1, 1995, through December 31, 1995.

In our opinion, except for the effect of the matter discussed in the preceding paragraph, the schedule of Rates of Return of XYZ Capital Management, Inc. for the above-stated investment period is fairly stated, in all material respects, in conformity with *[list the established criteria that form the basis for the presentation]*.

[Signature]

[Location]

[Date]

Exhibit D

Sample Report for a Public Accountant Engaged to Examine All
Years in a Ten-Year Presentation, With the Current Year in
Compliance With the AIMR Standards and the Preceding Years
Presented in Accordance With Other Criteria^{3, 4, 5}

Report of Independent Public Accountants

To XYZ Capital Management, Inc.:

We have examined the accompanying schedule of Rates of Return for the *[list the descriptions of the composites to be examined]* of XYZ Capital Management, Inc. (the "Company") for the annual and compounded investment periods from January 1, 1986, through December 31, 1995. This schedule is the responsibility of the Company's management. Our responsibility is to express an opinion on this schedule based on our examination. Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary in the circumstances.

As described in Note X to the schedule, the Company adopted the *[list the established criteria that form the basis for the presentation]* as of January 1, 1993.

In our opinion, the schedule of Rates of Return of XYZ Capital Management, Inc. for the annual and compounded investment periods from January 1, 1993, through December 31, 1995, is fairly stated, in all material respects, in conformity with *[list the established criteria that is the basis for the presentation]*.

The rates of return for the annual and compounded investment periods from January 1, 1986, through December 31, 1992, were prepared in accordance with the measurement and disclosure criteria set forth in Note X and are not intended to, and do not, comply with *[list the established criteria that form the basis for the presentation]*. In our opinion, however, the schedule of Rates of Return of XYZ Capital Management, Inc. for the investment periods ended December 31, 1992, is fairly stated, in all material respects, in conformity with the basis of the measurement and disclosure criteria set forth in Note Y.

[Signature]

[Location]

[Date]

³Because two different criteria are used, the reader may misunderstand the comparability between these two criteria. In such circumstances, the practitioner may add a paragraph to the report as follows, "If the Rates of Return for the annual and compounded investment periods January 1, 1986, through December 31, 1992, were prepared on the same basis as that described in Note X, they might influence the users' conclusions about the investment performance of XYZ Capital Management, Inc."

⁴This sample report assumes the presentation includes ten years of historical data. This sample would also be applicable if the presentation included a shorter period of time provided it was since inception of the firm or composite or met the minimum time period requirements of the applicable established criteria.

⁵This example is applicable only to situations in which clients initially adopt the AIMR *Performance Presentation Standards* and choose not to restate their historical numbers. This example assumes that the overall presentation is otherwise in compliance with the AIMR standards and restatement is not required. Note that performance statistics must be in compliance beginning January 1, 1993.

Exhibit E

Sample Report for a Public Accountant Engaged to Examine All Years in a Ten-Year Presentation, With an Exception^{6, 7, 8}

Report of Independent Public Accountants

To XYZ Capital Management, Inc.:

We have examined the accompanying schedule of Rates of Return for the *[list the descriptions of the composites to be examined]* of XYZ Capital Management, Inc. (the "Company") for the annual investment periods from January 1, 1986, through December 31, 1995. This schedule is the responsibility of the Company's management. Our responsibility is to express an opinion on this schedule based on our examination. Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary in the circumstances.

[List the established criteria that form the basis for the presentation] guidelines require the use of accrual accounting for fixed-income securities. As more fully discussed in Note X to the schedule of rates of return, the investment performance statistics were calculated using cash-basis accounting for fixed-income securities, with the effects not reasonably determinable.

In our opinion, except for the effect of the matter discussed in the preceding paragraph, the schedule of Rates of Return of XYZ Capital Management, Inc. is fairly stated, in all material respects, for the above-stated investment periods, in conformity with *[list the established criteria that form the basis for the presentation]*.

[Signature]

[Location]

[Date]

⁶This sample report assumes the presentation includes ten years of historical data. This sample would also be applicable if the presentation included a shorter period of time provided it was since inception of the firm or composite or met the minimum time period requirements of the applicable established criteria.

⁷This sample assumes the composite did not hold such a significant amount of fixed-income securities as a percentage of the composite to render the performance misleading and cause an adverse opinion. This area requires a significant amount of judgment. The practitioner must satisfy himself or herself that the effect would not be material enough to warrant an adverse opinion. The presumption should normally be to issue an adverse opinion, unless the practitioner can satisfy himself or herself otherwise.

⁸The *ATMR Performance Presentation Standards* do not allow the asset-management firm to claim compliance unless the results are in full compliance with those standards with no exceptions.

Exhibit F

Sample Report for Reporting Issues When Significant Estimates Are Used^{9, 10}

Report of Independent Public Accountants

To XYZ Capital Management, Inc.:

We have examined the accompanying schedule of Rates of Return for the *[list the descriptions of the composites to be examined]* of XYZ Capital Management, Inc. (the "Company") for the annual and compounded investment periods from January 1, 1986, through December 31, 1995. This schedule is the responsibility of the Company's management. Our responsibility is to express an opinion on this schedule based on our examination. Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary in the circumstances.

In our opinion, the schedule of Rates of Return of XYZ Capital Management, Inc. is fairly stated, in all material respects, for the above-stated investment periods, in conformity with *[list the established criteria that is the basis for the presentation]*.

As discussed further in Note X, the Company's rates of return are based in part on investment securities valued at \$X,XXX,XXX at December 31, 1995 *[% of the composite]*, whose values have been estimated by management in the absence of readily ascertainable market values. We have reviewed the procedures used by management in arriving at its estimate of the value of such securities and have inspected the underlying documentation and, in the circumstances, we believe the procedures are reasonable and the documentation appropriate. However, management's estimate of value and the resulting reported rates of returns may differ significantly from the values that would have been used and the rates of return that would have been reported had a ready market existed for the securities, and the differences could be material.

[Signature]

[Location]

[Date]

⁹The total value of securities valued by management or the general partner and the corresponding percentage of the total value of the composites for the current year should be disclosed in the practitioners' report and in the accompanying footnotes to the schedule of rates of return for each year presented.

¹⁰This sample report assumes the presentation includes ten years of historical data. This sample would also be applicable if the presentation included a shorter period of time provided it was since inception of the firm or composite or met the minimum time period requirements of the applicable established criteria.

Exhibit C

Sample Report for a Public Accountant Engaged to Perform a Level I Examination¹¹

Report of Independent Public Accountants

To XYZ Capital Management, Inc.:

We have examined XYZ Capital Management, Inc. (the "Company") management's assertion that all of the Company's actual, discretionary, fee-paying portfolios are included in at least one composite for the annual and compounded investment periods from January 1, 1986, through December 31, 1995. Our responsibility is to express an opinion on this assertion based on our examination. Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary in the circumstances.

We have not been engaged and did not examine the validity and calculation of the Rates of Return of XYZ Capital Management, Inc. for the annual and compounded investment periods from January 1, 1986, through December 31, 1995, and, accordingly, do not express an opinion thereon.

In our opinion, the assertion referred to above of XYZ Capital Management, Inc.'s management is fairly stated, in all material respects, in conformity with the *AIMR Performance Presentation Standards 1993*.

[Signature]

[Location]

[Date]

¹¹This sample report assumes the presentation includes ten years of historical data. This sample would also be applicable if the presentation included a shorter period of time provided it was since inception of the firm or composite or met the minimum time period requirements of the applicable established criteria.