T.C.
MARMARA ÜNİVERSİTESİ
SOSYAL BİLİMLER ENSTİTÜSÜ
İNGİLİZCE İŞLETME ANA BİLİM DALI
İNGİLİZCE MUHASEBE - FİNANSMAN BİLİM DALI

FINANCIAL REPORTING RULES, PERFORMANCE PRESENTATION STANDARDS AND PERFORMANCE MEASUREMENT

(Yüksek Lisans Tezi)

Ayşe DİRİK GÜRLÜMAN

Danışman : Doç. Dr. E. Abdülgaffar Ağaoğlu

İSTANBUL - 1997

ACKNOWLEDGMENT

I would like to thank to Doç. Dr. E. Abdülgaffar Ağaoğlu, my thesis advisor, who gave me invaluable guidance, encouragement and support throughout my research without which this thesis would have never been completed.

I also wish to convey my profound gratitude to Doç. Dr. Necdet Şensoy and Yrd. Doç. Dr. Türkan Önder, who have furnished me with feedback, criticisms and suggestions. It has been a pleasure working with them.

Finally, my greatest debt is to my husband and my parents who have supported me with their patience and love.

ABSTRACT

The pressure for more uniform international accounting rules arises from two factors: increased internationalization of the markets in which accounting reports are used, and increased globalization of the political processes that regulate those markets. The result of international comparisons of accounting systems is that there is no one 'true' way of doing accounting. However, the differences among countries are diminishing. It can be seen that internationalization of accounting is proceeding apace, but this process is along complex and uncertain paths. Firstly and most importantly, each country should establish uniformity in its own accounting practices and internationalization of accounting will then follow it. Unfortunately, in Turkey, the accounting practices are not uniform yet. The efforts spend to make 'accounting practices' and 'preparation and presentation of financial statements' more uniform are advantageous for investment managers, because the financial statements are utilized by investment managers in their decision making process. The uniformity of these statements make them more reliable and this leads investment managers to make better investment decisions. Also, by eliminating the wrong investment decisions only because of the utilization of unreliable financial statements as a source of information, uniformity provides better picture of the performance of the investment managers. There are also efforts to identify a clear set of guidelines that would become a model for use by investment managers and to bring about an awareness and a standardization with regard to the presentation and measurement of performance in the industry. Also creation of a code of ethics to accompany the proposed standards is another issue that is worked on. The central aim is to make it more difficult for investment managers and advisors to manipulate the numbers, and thus to insure that clients and prospects are treated more fairly than they have been in the past.

ÖZET

Finansal raporların kullanıldığı piyasaların ve bu piyasaları düzenleyen politik süreçlerin globalizasyonu daha tekdüze uluslararası muhasebe standartlarına geçiş yönünde baskılar oluşturmaktadır. Bir muhasebe sistemi ait olduğu ülkenin piyasalarının özelliklerine ve izlediği politikalarına göre düzenlendiğinden, birbirinden çok farklı olan ulusal muhasebe sistemleri karşılaştırıldığında tek bir doğru muhasebe uygulamasının olmasının mümkün olmadığı görülmektedir. Buna rağmen ülkeler arasındaki uygulama farklılıklarının gitgide azaldığı dikkat çekmektedir. Muhasebe uygulamalarının uluslararası hale getirilmesinde oldukça yol katedilmiş olmasına rağmen, bunun karışık ve belirsizliklerle dolu bir süreç olduğu da kabul edilmelidir. İlk önce her ülke kendi muhasebe uygulamalarında tekdüzeliği sağlamalıdır. Ancak bunun ardından muhasebe uygulamalarının tekdüzeliğinin uluslararası olarak sağlanması mümkün olacaktır. Malesef Türkiye'de henüz muhasebe uygulamalarında tekdüzen sağlanamamıştır. Yatırım yöneticileri açısından muhasebe uygulamaları ile finansal tabloların hazırlanış ve sunuş esaslarının daha tekdüze bir hale getirilmesi yönündeki çalışmalar avantaj teşkil etmektedir, çünkü bu finansal tablolar yatırım yöneticileri tarafından yatırım kararları verirken kullanılmaktadır. Bu tabloların tekdüze olması onları daha güvenilir kılmakta, bu da yatırım yöneticilerinin daha isabetli yatırım kararları almasına katkıda bulunmaktadır. Ayrıca, tekdüze hazırlanmamış mali tabloların kullanımından doğabilecek yanlış yatırım kararları ortadan kalkacağından, yatırım yöneticisinin performansı daha doğru bir şekilde ölçülebilecektir. Yatırım yöneticileri tarafından rehber olarak kullanılmak üzere standard bir model geliştirilmesi ve endüstrideki performans ölçüm ve sunumunun standard bir hale getirilmesi yönünde çalışmalar mevcuttur. Ayrıca, bu standartları tamamlayıcı ahlak kurallarının da oluşturulmasına çalışılmaktadır. Burada amaç yatırım yöneticilerinin ve yatırım danışmanlarının rakamları kendi lehlerine manipüle etmelerini önleyerek müşteri (yatırımcılar) ve müşteri adaylarına geçmiştekinden daha adil davranılmasını sağlamaktır.

TABLE OF CONTENTS

LIST OF TABLES

LIST OF ABBREVIATIONS

AIA	:American Institute of Accountants
AICPA	:American Institute of Certified Public Accountants
AIMR	:Association for Investment Management and Research
APB	:Accounting Principles Board
ASR	:Accounting Series Release
BAI	:Bank Administration Institute
CAP	:Committee on Accounting Procedure
CFA	:Chartered Financial Analyst
CMB	:Capital Market Board
CML	: Capital Market Law
CPPS	:Committee for Performance Presentation Standards
EAFE	:Morgan Stanley Capital International Europe / Australia / Far East Index
EU	:European Union
FAF	:Financial Analysts Federation
FASB	:Financial Accounting Standards Board
GAAP	:Generally Accepted Accounting Principles
IAS	:International Accounting Standard
IASC	:International Accounting Standards Committee
ICAA	:The Investment Counsel Association of America
ICFA	:Institute of Chartered Financial Analysts
IFAC	:International Federation Of Accountants
IOSCO	:International Organization Of Securities Commissions
MSCI	: Morgan Stanley Capital International
R&D	:Research and Development
SEC	:Securities and Exchange Commission
S&P	:Standard and Poor's
TMS	:Turkish Accounting Standard
TMUDESK	: Accounting And Audit Standards Board Of Turkey
TÜRMOB	: Union Of Chambers Of Certified Public Accountants Of Turkey
U.K.	:United Kingdom

U.S.A. :United States of America

INTRODUCTION

Accounting information demand comes from all parties who could potentially transact with the corporation. These includes who might buy its shares, write analysts' reports about it, lend to it, work for it, or even buy its products. Almost all democracies have a tradition of 'public disclosure' of providing free accounting and other information to all, because the range of actual and potential parties transacting in markets with publicly traded corporations is so large. It can be concluded that, accounting rules are shaped primarily by the various needs of users. They are also affected by politics[1].

Accounting rules are shaped ultimately by economics and politics, so it is not come as surprise that two related developments drive the push for *international* accounting rules. First one is the progressive *globalization* of the markets in which accounting reports are utilized. And, second one is the increased *internationalization* of the political influences on accounting[2].

How markets and politics are conducted differ among countries, because accounting is an integral part of economic and political institutions of each country. The result of international comparisons of accounting systems is that there is no one 'true' way of doing accounting. Also, accounting rules is an integral part of the markets and politics of each country, and among countries these forces differ substantially. However, the differences among countries are diminishing. Until such time, almost all barriers have disappeared and globalization of the capital markets will likely to continue[3].

If we consider financial reporting alone, there are lots of problems to consider. The most important problem is the analysts' needs for internationally acceptable standards of financial reporting. These includes encompassing common accounting methods, adequate detailed disclosure, sufficient frequency of reporting, and credible auditing or other reliability enhancement[4]. The work conducted on these issues are discussed in detail in this thesis.

---

[1] Ball, Ray, 'Making Accounting More International: Why, How, And How Far Will It Go?', The Bank Of America, Journal Of Applied Corporate Finance, Fall 1995, Volume 8, Number 3, pp.20.
[2] ibid.
[3] ibid.
[4] ibid.

What effects financial reporting rules have on corporate decisions is a question which has become increasingly important when the impact of government regulation on the allocation of resources is considered[5]. One of the purposes of this thesis is to add insight into the impact of the regulation of financial reporting on corporate decisions. Toward this end, the thesis examines the process which has led to a policy of increased regulation.

Disclosure and *measurement* are the two fundamental areas of regulation in financial reporting. Also, when considering investment performance, it is important to distinguish among the different objectives that one might have. The difference between the *performance measurement* and *performance evaluation* is the first distinction. Performance measurement is just an accounting function which tries to reconcile end-of-period with beginning-of-period values. But, performance evaluation addresses the issues of how the measured return was attained, whether it was due to skill or chance, and whether future results will be similar. There are lots of ways of measuring returns. The method chosen by an individual depends on the specific performance evaluation objectives[6]. These ways of measuring return will also be discussed in detail in this thesis.

The thesis consists of five sections. In the first section, accounting systems in the world and their comparisons are summarized. The questions of 'why accounting systems differ?' and 'why internationalization of accounting rules is needed?' are also discussed in detail.

In the second section, the competing/conflicting objectives of the firms, investors, creditors and regulators in the determination of disclosure and measurement rules are discussed. Also, effects of measurement rules imposed on the firms are summarized.

In the third and fourth sections, rules on measurement and presentation of investment performance both in Turkey and U.S.A. are discussed in detail.

---

[5] Horwitz, Bertrand, 'Financial Reporting Rules And Corporate Decisions' Contemporary Studies In Economic And Financial Analysis; v.36, 1982, pp.1.

[6] The Institute of Chartered Financial Analysts and the Financial Analysts Federation, 'Performance Measurement: Setting the Standards, Interpreting the Numbers', 1989, p.2.

Lastly, in the fifth section, another aspect of financial reporting, namely the ethics, is discussed. Ethical rules about financial reporting both in Turkey and U.S.A. are summarized.

An empirical research is also conducted in order to see the situation in Turkey. The pitfalls of the Turkish practice about the measurement and presentation of investment performance and some recommendations included.

1. THE TREND TOWARD UNIFORMITY IN ACCOUNTING RULES

There can be general agreement about how important commercial transactions are to be implemented because there exist accounting rules . Accounting information is used in a variety of corporate transactions and acceptable rules of accounting must be arrived to allow them to proceed. In sum, *Generally Accepted Accounting Rules* have an important effect on how corporations transact. If you change the accounting rules, you change how corporations behave.[7] The considerations that shape decisions about the arrangement of information in financial reporting are as follows: Aggregation, classification, structure, articulation, accounting policies, notes and supplementary information[8].

Accounting rules are imposed by standard-setting bodies that tend to be developed in one of two basic ways: First one is to grow out of the accounting profession and remain part of the private sector, as this is the case in the U.S.A. Financial Accounting Standards Board (FASB) and the U.K.'s Accounting Standards Board. The alternative to the first way is to originate in and remain part of the government. The French Conseil National de la Comptabilité is an example. Accounting rules are guided ultimately by two factors: market economics and politics, whether the standard-setting body is part of the private or the public sector[9].

Market demand is the main determinant of accounting rules. The corporations incur the preparation costs, because financial statements are used in transacting with corporations. Another determinant of accounting rules is politics and politicians. The politicians find ways to interfere with almost everything by virtue of their control over regulators. Across countries, across time, and with the accounting issue involved, the relative importance of the market and the political influences varies. In sum, the pressure for more *uniform international* accounting rules arises from two factors: increased *internationalization* of the markets in which accounting reports are used, and increased *globalization* of the political processes that regulate those markets[10].

---

[7]Ball, op. cit.,pp.19.
[8]MCB University Press, 'Presentation of Financial Information', January 1992 (109/1181), pp.98.
[9] Ball, op.cit.,pp.20.
[10] ibid.

Accounting information demand comes from all parties who could potentially transact with the corporation. These includes those who might buy its shares, write analysts' reports about it, lend to it, work for it, or even buy its products. Almost all democracies have a tradition of 'public disclosure' of providing free accounting and other information to all, because the range of actual and potential parties transacting in markets with publicly traded corporations is so large. The primary demand for accounting information is created by the enormous variety of market uses. This means that the market itself has the primary influence on the rules that accountants use to report that information[11].

The second effect on accounting is politics. In most countries, the political process has a strong influence in the process of writing the accounting rules, though the mechanisms for doing so differs substantially. For example, an agency of the U.S.A. Government, namely the Securities and Exchange Commission (SEC), has legal oversight over U.S.A. accounting rules under the U.S.A. Securities Acts. Even though the SEC delegates this function to a private-sector body, namely the Financial Accounting Standards Board (FASB), it flexes its regulatory power whenever it disapproves of what is being done[12].

The politics of accounting differ across countries. The SEC's aim is primarily to protect small investors from losses, but for example Japanese rule-making has been dominated by the interests of institutional lenders, companies and investors. Under the guidance of the 'Business Accounting Deliberation Council', the Ministry of Finance codifies accounting rules together with the Japanese Institute of Certified Public Accountants in Japan. Politics influence accounting rules in every country in some way in spite of the differences in political processes[13].

How managers exercise any choice among accounting methods they are allowed by the rules is also influenced by politics (for example, in deciding which method of depreciation to use). This is especially important in politically-sensitive subjects like defense contracting, utilities, and corporations with large organized-labor payrolls. These corporations are more likely to choose

---

[11] ibid.
[12] ibid.
[13] ibid, pp.21.

conservative accounting methods in order to make them look less profitable and to avoid attracting political attention.[14]

Accounting is also affected by political process through tax accounting rules. Tax laws have a large direct effect on accounting rules in some countries including France, Germany, Japan and most of South America. That is because of the usage of the same or similar rules to calculate both a company's taxable income and the income that will be reported in its public financial statements. For example, German firms routinely take charges against taxable income that are essentially extra depreciation charges and report highly conservative income statements and balance sheets. That is because the German tax rules and the Commercial Code require the practice of taking charges against taxable income to be reflected in the published accounts[15].

However, tax rules have less effect and there are important differences between reported (book) and tax income in the U.S.A.. There are subtle interactions between tax rules and accounting rules even in countries that do not equate reported accounting income and taxable income. The reason behind this is: transactions-recording system of the firm is used in order to prepare both. It can be summarized that, accounting rules are shaped primarily by the various needs of users and are also affected by politics[16].

Accounting rules are shaped ultimately by economics and politics, so it is not come as surprise that two related developments drive the push for international accounting rules. First one is the progressive *globalization* of the markets in which accounting reports are utilized. And, second one is the increased *internationalization* of the political influences on accounting[17].

There is an acceleration in the globalization of markets and political processes in recent times due to many things. The drastic reduction of the costs of producing, communicating, accessing, processing and interpreting information is the largest single driving force. It is known that one of the most important inventions in history is the electronic computer. Invention after invention has

---

[14]Watts, Ross L. and Jerold Zimmerman, 'Towards a Positive Theory of the Determination of Accounting Standards', Accounting Review (Jan 1978): pp. 112-134.
[15] Ball, op.cit.,pp.21.
[16] ibid.
[17] ibid.

reduced almost every component of information costs at a rapid pace. As a consequence, cross-border transacting has mushroomed. International communications and transactions, until very recently were the province of a managerial elite, today are routine for low-level operational employees. Many markets are reshaped by low-cost access to an abundance of international information. Managers, employees, suppliers, investors and customers now live and work in a 'global village'. The demand for the internalization of accounting is emerged, when such people use accounting information in international transactions. This means that they create a demand for accounting standards that transcend national boundaries. Trading across borders requires cross-border trading institutions. Politics is becoming more international also.

Below, the way in which accounting rules are becoming more global will be summarized. But, first the way in which accounting rules differ across countries, and why they differ should be described.

1.1. NATURE AND CAUSES OF NATIONAL DIFFERENCES IN ACCOUNTING RULES

Accounting is an integral part of the economic and political institutions of each country. How markets and politics are conducted differ enormously among countries. But, countries can be categorized into three distinct accounting groups: *Anglo-American, Continental European*, and *South American.*[18]

Anglo-American group, consisted of over 30 countries, is the largest group. Its accounting institutions were developed in England and Scotland. They were also exported to most of the former British Colonies (including the U.S.A.) and to countries that were early in building multinational corporations (notably, the Netherlands). Canada, Hong Kong, India, Indonesia, Israel, Kenya, Mexico, Nigeria, Philippines, Singapore, South Africa, and Zimbabwe are also included in this group[19].

---

[18]ibid,pp.22.
[19] ibid.

Case law and precedent have a greater impact on accounting than does codified law, because these are 'common-law' countries. It is called 'Common-law', because it arises from the commonly-accepted practices of the market place. When a practice becomes commonplace, the courts apply it to subsequent commercial agreements, and this practice becomes a rule[20].

By common law, parties to a transaction, who share no close ties to reach an agreement, have the assurance that an independent body will interpret it against a rich background of common practices. When entering complex, long-term transactions, close ties between parties are thus not needed. Common-law countries tend to have more active public capital markets, because this style of legal system supports transacting by parties without close ties[21].

Accounting rules in the Anglo-American group have been determined largely in the private sector and oriented toward disclosure across the market to interested parties. These parties are presumed by the courts (and by agencies such as the SEC) to rely entirely on publicly-disclosed information, because they have no close ties with the corporation[22].

The legal system and the accounting rules are codified by government ministries in the *Continental European* group. Close interaction between government and major players is necessary because codified law relies upon the government ministries processing an acute knowledge of contemporary commercial affairs. The major players must be few in number and corporate capital must be largely supplied by banks and other institutional investors for the system to work. When compared to common-law countries, transactions in such countries tend to be based more on private information and less on public information[23].

Including Belgium, Denmark, France, Germany, Italy, Norway, Spain and Sweden, most continental Europe falls into this group, as do several small former colonies. Japan also belongs to this group. Relatively close interaction between markets and governments in most aspects of

---

[20] ibid.
[21] ibid, pp.23.
[22] ibid.
[23] ibid.

business also extends to the imposing of accounting rules. The accounting and tax rules in these countries are very similar and, in many cases, even the same[24].

Public disclosure plays a comparatively modest role in shaping accounting rules because of the dominating role of private communication with banks and other groups with close links to the companies and to government in Japan and much of continental Europe. One of the consequences of the reduced emphasis on public disclosure is lower number of public corporations. For example, in 1993, while Germany had 425 corporations with publicly-listed shares, Britain -a much smaller European economy operating under a different tradition - had 1,950[25].

The dominating influences in most South American countries are the legal and administrative systems inherited from Spanish (and Portuguese) colonization and highly political environment that results from such systems. The most important differences between *South American* and Continental European accounting, which can both be characterized as government-administered systems, come from the special problems and requirements caused by the persistently high inflation experienced by these countries. Inflation requires extensive modification of accounting rules. For example, countries like Brazil and Argentina have been forced to implement accounting rules to provide constant-dollar financial statements, in order to see inflationary gains and losses clearly and separately identified[26].

The institutional differences among these groups - especially, between the Anglo-European and the other two groups - are important and fundamental. While such differences are being lowered by modern communication costs, they seem resilient. Also, there are further differences within the three individual categories cited above. According to European accountants, Germany, France and Italy cannot be put in the same category. That is because while the German accounting code is written in general terms and allows considerable discretion, the French code is more rigid[27]. Also, some countries do not fit within any category very well.

---

[24] ibid.
[25] ibid.
[26] ibid.
[27] ibid.

The country that has minimum financial disclosure rules is Switzerland. All large multinational Swiss corporations disclose well in excess of these requirements because they transact with international lenders, investors, customers, suppliers, labor unions and managers, but other Swiss firms under no requirement to do so[28].

Turkey is included in the *Continental European* group. In order to establish a legal framework after the establishment of Turkish Republic, several laws of the several countries (for example, Italy, France, Switzerland) are taken and adopted to Turkey.

The result of international comparisons of accounting systems is that there is no one 'true' way of doing accounting. Also, accounting rules is an integral part of the markets and politics of each country, and among countries these forces differ substantially.

1.1.1. TURKISH ACCOUNTING SYSTEM

At present, there is no set of Generally Accepted Accounting Principles that apply equally to all Turkish companies, although over the past few years there have been some tentative steps in that direction. Instead, there are general rules that govern the aspects of accounting in the Tax Procedures Code. In addition to these general rules, there are other rules that apply specifically to banking and insurance companies and to companies registered with the Capital Market Board (CMB)[29].

The most recent development has been the introduction of a Uniform Chart of Accounts. It prescribes certain fundamental accounting concepts, a code of accounts, and a format for the presentation of financial statements which, with the exceptions listed below, are applicable to all companies in Turkey from January 1, 1994 onwards[30]. There is an exemption for the following corporations only about prescribed Financial Statements and Uniform Chart of Accounts. This

---

[28] ibid.

[29] Erdikler-Eratalar YMM AŞ., Arthur Andersen & Co., SC; Yapı ve Kredi Bankası AŞ.,'Doing Business in Turkey', pp.59-60 .

[30] ibid.

means that these corporations are also obliged to comply with Fundamental Principles of Accounting, Disclosure of Accounting Policies and Principles of Financial Statements.[31]

- Banking and Insurance Companies
- Private Finance Institutions
- Leasing and Factoring Companies
- Mutual Funds, Institutions, and Investment Trusts.

All the business entities, that perform commercial and industrial operations and have an accounting system depending on double-entry, are obliged to comply with this prescription about " Uniform Accounting System"[32].

Some of the business entities, which are not obliged to have a double-entry accounting system by Tax procedural Code, must comply with only 'Fundamental Principles of Accounting'. Also, there is an exemption for Single Proprietorships and Ordinary Partnerships, only for those which are obliged to have a double-entry accounting system, and General Partnerships and Limited Partnerships about being obliged to prepare the Supplementary Financial Statements according to the total amount of assets and volume of the operations. In other words, in order to be obliged to prepare Supplementary Financial Statements, the specified limits in the law must be exceeded by this corporations[33].

The basic elements of the Uniform Chart of Accounts are as follows[34]:

1. The accounting entries should be made according to the following twelve fundamental concepts[35]:

---

[31] Şensoy, Necdet, 'Selected Topics On Turkish Tax Accounting', Marmara Üniversitesi Yayın No: 550, İktisadi ve İdari Bilimler Fakültesi Yayın No: 397, İstanbul, 1994, pp.125.
[32] ibid.
[33] ibid, pp.126.
[34] Erdikler-Eratalar YMM AŞ., op.cit., pp.59-60.
[35] Akdoğan, Nalan; Orhan Sevilengül, 'Tekdüzen Muhasebe Sistemi Uygulaması', İstanbul Serbest Muhasebeci Mali Müşavirler Odası Yayınları, Yayın No:7, pp.5.

- *Social Responsibility:* Interests of the society, not interests of the persons or groups, should be given priority, when organizing accounting, conducting accounting applications and also in the process of preparation and presentation of financial statements. So, information provided should be true, objective and honest.

- *Specific-Separate Business Entity:* The business entity is a separate entity, which is independent of its owners and the accounting procedures of this business entity should be conducted according to this.

- *Going Concern (Continuity):* The life of a company is assumed as endless and does not limited with the lengths of the lives of its owners.

- *Periodicity:* The life of a company, which is assumed as endless, is divided into time periods and each time period's activity results are ascertained independent of the other periods.

- *Money-Measuring Unit:* The economic events and activities, if they can be expressed in terms of money, should be reflected in terms of money as a unique measure.

- *Historical Cost:* The assets and services acquired by the firm should be recorded at their initial costs.

- *Objective And Verifiable Evidence:* Accounting entries should reflect the real situation of the entity. They should be relied on objective documents. Also, the accounting methods used should be chosen objectively.

- *Consistency:* The accounting methods used should be applied consistently in the periods following each other. The accounting methods can be changed, if valid reasons exist. But this changes and their monetary affects should be indicated in the financial statements.

- *Full And Fair Disclosure:* The financial statements should be clear and sufficient information should be included.

- *Concept Of Prudence:* The business entities should consider the potential risks, which can be faced by the firm. They should have allowances for expected losses and expenditures.

- *Materiality:* An account or a monetary event should have enough weight in order for it to be used in valuations or in decision making based on financial statements.

- *Substance Over Form:* When making accounting entries, the substance of the event should be considered rather than its form.

2. The balance sheet starts with the items that are most liquid. Non-current items are listed at the bottom. (This system is contrary to the EU's balance sheet model.)

3. There are two alternatives for cost accounting[36]:
- The **A type** tracks each transaction recorded according to three classifications: function, type of expense, and cost center.
- The **B type** tracks the costs recorded according to the type of expense.

At the year end, the accumulated data should be reclassified according to the function. The B type is for small businesses, whereas A type is for medium and large businesses.

4. Five statements must be submitted to tax authorities, if a company's net sales exceed TL 750 billion or total assets exceed TL 300 billion. The financial statements are as follows:
- Balance sheet
- Income statement
- Cost of sales statement
- Cash flow statement
- Profit appropriation

[36] Erdikler-Eratalar YMM AŞ., op.cit., pp.59-60.

1.2. HOW INTERNATIONALIZATION IS BEING ACCOMPLISHED

As it is mentioned before, the differences among countries are diminishing. In response to the drastic reduction in the cost of transacting internationally, institutional structures are also changing rapidly. As part of this, accounting is internationalizing rapidly. The internationalizing process is summarized below.

It is observed that some companies have adopted their own solutions to internationalization in various countries. One simple solution is preparing 'convenience statements', which is just the translation of a firm's financial statements into a foreign language but still using home-country accounting rules. Also, some companies prepare 'parallel' financial statements, under the rules of one or more foreign countries in which they have business relations. But, some companies are trying to reach more globally acceptable accounting methods. For example, some French, German and Swiss corporations now prepare their consolidated group financial statements under International Accounting Standards Committee (IASC) rules. These rules, as explained below, are likely to have many aspects of Anglo-American accounting practice. In addition, as the clients of the accounting firms engage in more international transactions, the accounting firms that audit the transactions have to become more international[37].

There is an increasing competition among financial markets on a worldwide basis to attract listing by foreign firms. This forces markets and regulators to accept financial statements prepared under foreign or IASC rules. For example, the London and Hong Kong Stock Exchanges accept financial statements prepared under IASC standards as satisfying their listing requirements. A worldwide coalition of regulatory bodies, namely the International Organization of Securities Commissions (IOSCO), is working with IASC in developing its standards. IOSCO has announced that it will defer considering recognition of the IASC standards until they are completed, but it seems that it will increase the pressure on countries' regulatory bodies to accept the standards set by IASC[38].

---

[37] Ball, op.cit., pp.24.
[38] ibid.

There are pros and cons for corporations in listing their stock on foreign exchanges. Pros include increasing opportunities for raising new debt and equity capital, increased liquidity, and better hedging of its profits against the currency risk faced by investors. The cons include costs of listing fees and costs of complying with foreign regulations, including the considerable costs of preparing statements according to foreign requirements[39].

1.2.1. ACCOUNTING AND AUDIT STANDARDS BOARD OF TURKEY (TMUDESK)

Accounting And Audit Standards Board Of Turkey (TMUDESK) is established by Union Of Chambers Of Certified Public Accountants Of Turkey (TÜRMOB) in 1994. All parties that make use of accounting in Turkey are represented in TMUDESK. It is an independent entity. TMUDESK is also a member of IASC. TMUDESK has 60 members, some of them are appointed by TMUDESK and some of them are representatives of the interested parties[40].

Eleven Standards are established by TMUDESK since 1994. Also, it is working on new Standards, which are hoped to be released soon. TMUDESK is expected to be divided into two Boards, namely the Accounting Standards Board and the Auditing Standards Board, in the future. As it is the case in other countries, while the Accounting Standards Board will be an independent Board, the Auditing Standards Board will be included in TÜRMOB[41].

The major aim of TMUDESK is to establish uniformity in accounting principles. Another aim of TMUDESK is to establish the audit standards, which will be applied in independent auditing process. The following principles are assumed by TMUDESK in the process of establishing national standards[42]:

- The national standards that are established by TMUDESK should be harmonious to the international standards and,

---

[39] ibid.
[40] TMUDESK, 'Türkiye Muhasebe Standartları 1997', TÜRMOB Yayın No: 32, TMUDESK Seri No: 1, 1997, pp.iii.
[41] ibid.
[42] ibid., pp.3.

- The structure and the needs of the Turkish economy and the firms should be considered, when establishing standards.

The standards established by TMUDESK (eleven standards) become effective on January 1, 1997. Standards imposed by TMUDESK are prepared under the light of basic principles of accounting, current practices and international accounting standards. These eleven standards, namely the Turkish Accounting Standards (TMS), are given below. Also, the International Accounting Standards (IAS), that are same as or similar to the Turkish Accounting Standards are given in the parenthesis. For example, TMS 1 is nearly the same with IAS 1.

1. Disclosure of the accounting policies (TMS I, IAS I)
2. Financial reporting in high inflation periods (TMS II, IAS 6, 15,29)
3. Cash flow statements (TMS III)
4. Sales and other ordinary revenues (TMS IV, IAS 18)
5. Standard of consolidated financial statements (TMS V, IAS 3)
6. Recording of the investments in subsidiaries (TMS VI, IAS 27)
7. Recording of investments (TMS VII, IAS 25)
8. Tangible and intangible long-term assets and assets subject to depletion (TMS VIII, IAS 16)
9. Depreciation accounting (TMS IX)
10. Standards of net income or loss, basic mistakes and changes in accounting policies (TMS X)
11. Segment Reporting (TMS XI, IAS I4)

1.2.2. *CAPITAL MARKET BOARD (CMB) IN TURKEY*

As the Turkish economy, developed especially in the 1980's, there was a growing need for a new regulatory system to govern the country's capital market. To meet this need, the CML (Statute 2499) was passed on July 30,1981. Prior to this date, a number of draft bills had been prepared to address a variety of identified gaps in the current legislation. The legal framework governing the capital market has reached its current form with the issuance of Statute 3794 on May 13, 1992[43].

[43] Erdikler-Eratalar YMM AŞ., op.cit., pp.59-60.

Detailed regulations are contained in a series of appendices to the CML. The organization and the working principles of the CMB, the basic principles of independent external auditing, the activities of brokerage institutions and the provisions concerning markets for precious metals and gold are set in these regulations.

As a general rule, the law mandates that the capital market instruments issued or offered to the public must be registered by the Board. Registration procedures, issuance limits, sales methods, obligations concerning the use of brokerage institutions and obligations after issuance are also set in the communiques[44].

Issuers may sell capital instruments in both local and international capital markets. Shares issued by Joint-Stock Companies that have more than 100 shareholders must be registered by the CMB and assumed as publicly held company. Meanwhile, if publicly held company owns directly or indirectly more than 50 percent shares of another company, this company is also assumed as publicly held company[45].

Principles relating to the "Registered Capital System" regarding capital increases by companies without the need for a specific decision of the shareholders are governed by Article 12 of the law.

1.2.3. INTERNATIONAL ACCOUNTING STANDARDS COMMITTEE (IASC)

Until such time, as almost all barriers have disappeared, globalization of the capital markets will likely to continue. This change and its expected continuance have important implications for financial analysis. If we consider financial reporting alone, there are lots of problems to consider. These includes analysts' needs for internationally acceptable standards of financial reporting - encompassing common accounting methods, adequate detailed disclosure, sufficient frequency of reporting[46], and credible auditing or other reliability enhancement[47].

---

[44] ibid.
[45] ibid.
[46] Publicly owned companies are required to report quarterly in the U.S.A.. Exchange regulations require listed firms to send quarterly reports directly to shareholders. Private companies also tend to report quarterly to their creditors and other financial statement users. In most other countries, financial reports are issued semi-annually; in a few countries, only annual reporting is the norm. In Turkey, Capital Market Law requires quarterly reporting.

IASC has done a good job with allocating resources in bringing together accounting and standards-setting bodies from all around the world to discuss the problem of accounting standards. It has two successes up to now. First, by deeming idiosyncratic methods unacceptable and allowing to stand alternative methods that were followed in sizable portions of the world, it has codified accounting practice around the world. Its second success is its 'Improvements Project' to eliminate many remaining alternatives in practice, while at the same time initiating new projects (such as joint venture accounting and financial instruments) on which only few national standards currently exist[48].

IOSCO supports IASC's work, but its authority is limited with respect to the IASC's, to the willingness of sovereign governments to be persuaded to adopt its views. Also, the politics of international standard setting may be exacerbated because the IASC is composed primarily of representatives of national professional accounting bodies, rather than being an amalgamation of national standard-setting bodies[49].

Established in 1973, the IASC is a London-based coalition of professional accounting bodies from over 80 countries and it has adopted promulgating international accounting rules.[50] Until recently, the influence of the IASC has been limited because of not having assembled a complete set of accounting rules, but it has accelerated its standard-setting program and expects to complete a comprehensive set of rules by 1999. By the end of 1994, IASC had published 29 accounting standards that are about accounting for inventory, R&D, construction contracts, joint ventures, hyperinflation, and other issues[51].

The influence of the IASC is increasing rapidly and IASC is supported by most national accounting professions. Some countries (including Singapore, Malaysia and Hong Kong) have adopted IASC rules as their own rules after a small amount of changes. Also, most national

---

[47]AIMR, 'Financial Reporting In The 1990s And Beyond', 1993, pp.22-23.
[48] ibid.
[49] Ball, op.cit., pp.25.
[50]Durmuş, Ahmet Hayri, 'Uluslararası Muhasebe Standartları (1-31)', Türkiye Muhasebe Uzmanları Derneği Yayını No.7, İstanbul 1992, pp.5.
[51] AIMR, 'Financial Reporting In The 1990s And Beyond', 1993, pp.22-23.

bodies, when drafting their rules about an emerging problem now look for information on the consensus solution on a worldwide basis. In such cases, the IASC plays the role of coordinator[52].

1.2.4. OTHER INTERNATIONAL ACCOUNTING ORGANIZATIONS

There also many other international accounting institutions exist and so a wide variety of groups are involved. As an example, the International Federation of Accountants (IFAC) is a worldwide coalition of accounting bodies that operates in parallel to IASC by issuing non-binding standards for independent auditing of accounts. Other participating groups include the International Chamber of Commerce, the International Association of Financial Executives Institutes, the International Banking Association, the International Bar Association, O.E.C.D., and the United Nations Division on Transnational Corporations and Investment in addition to the IFAC[53].

Finally, it is important not to forget Eastern Europe and China. As these countries shift from planned to market economies, accounting firms are discovering an enormous opportunity to contribute to and profit from their development of accounting institutions 'from the ground up'. Accounting in the former Soviet Union could have been described as a conspiracy between accountant and plant manager to prove that the plant met its output quota. Because of this fact, the creation of a really independent accounting practice in Eastern Europe is not an easy task. Much of it will be imported from other countries[54].

From this short summary, it can be seen that internationalization of accounting is proceeding apace, but this process is along complex and uncertain paths.

1.2.5. EUROPEAN UNION (EU)

Firms operating in the member countries to comply with various EU directives is required by the EU. These include EU-wide accounting rules, disclosure practices, and requirements for practicing as an auditor[55]. Like many aspects of European unionization, implementation of the

---

[52] Ball, op.cit., pp.26.
[53] ibid.
[54] ibid.
[55] ibid.

important Fourth Directive is still controversial in many EU countries. For example, according to its Article 2: 'The annual accounts should give a true and fair view of the company's assets, liabilities, financial position and profit or loss.' The 'true and fair' requirement coming from British common-law origin and underlies the Anglo-American accounting model, and so differs much from the Continental-European model of codifying exact accounting rules. It specifies a criterion for rules to satisfy, and leaves the judgment the independent accountant in deciding whether the accounts are 'true and fair', but it does not codify those rules. Since EU and national laws operate together, one effect of Article 2 has thus been to put a common-law concept of 'true and fair' into the codified legal systems of some EU countries[56].

1.2.5.1. EUROPEAN COMMUNITY MEASURES ABOUT FINANCIAL REPORTING

The Council Directive 80/390/EEC of 17 March 1980 coordinating the requirements for the drawing up, scrutiny and distribution of the listing particulars to be published for the admission of securities to official stock exchange listing[57] aims to ensure improved protection of investors and a greater degree of equivalence in the provided protection, by coordinating requirements as to the information to be published at the time of admission[58].

In case of securities admitted to official stock exchange listing, the protection of investors requires them to be supplied with appropriate regular information. Coordination of requirements for this regular information has similar objectives to those imposed for the listing particulars, that is improving such protection and making it more equivalent, to facilitate the listing of these securities on more than one stock exchange in the Community, and in so doing to contribute towards the establishment of a genuine Community capital market by permitting a better interpenetration of securities markets[59].

---

[56] Commission Of The European Communities,'Securities Markets, Community Measures Adopted Or Proposed Together With Their Extension To The European Economic Area, Situation As Of June 1993', Luxembourg: Office For Official Publications Of The European Communities, 1993, pp.165.
[57]Official Journal No. L 100, 17.4.1980, p.1.
[58] Commission Of The European Communities,op.cit.,pp.165.
[59] ibid.

According to the Council Directive 79/279/EEC of 5 March 1979, which coordinates the conditions for the admission of securities to official stock exchange listing[60], listed companies must as soon as possible make available to investors their annual accounts and report giving information on the company for the whole of the financial year. The fourth Directive 78/660/EEC[61] has coordinated the laws, regulations and administrative provisions of the Member States about the annual accounts of certain types of firms.

Companies should also, at least once during each financial year, supply reports on their activities to investors. The Council Directive 82/121/EEC can, consequently, be confined to coordinating the content and distribution of a single report covering the first half of the financial year.[62]

The half-yearly report must enable investors to make an informed appraisal of the general development of the company's activities during the covered period by the report. But, this report should contain only the essential details on the financial status and general progress of the business of the company in question[63].

Because of the difficulties resulting from the current state of Laws in certain Member States, companies may have given a longer period to implement the provisions of the Council Directive 82/121/EEC[64] than that laid down for the adoption of national laws.

1.2.5.1.1. INFORMATION TO BE PUBLISHED ON A REGULAR BASIS

According to Article 1 of the Council Directive of 15 February 1982 on information to be published on a regular basis by companies the shares of which have been admitted to official stock exchange listing (82/121/EEC), this Directive will be applied to companies the shares of which are admitted to official listing on a stock exchange situated or operating in a Member

[60]Official Journal No. L66, 16.3.1979, p.21.
[61]Official Journal No. L222, 14.8.1978, p.11.
[62]Official Journal No. L48/26, 20.2.1982, p.1.
[63] Commission Of The European Communities,op.cit., pp.165.
[64]Official Journal No. L48/27, 20.2.1982, p.2.

State, whether the admission is of the shares themselves or of certificates representing them whether such admission precedes or follows the date on which this Directive enters into force[65].

However, this Directive will not apply to investment companies other than those of the closed-end type[66]. 'Investment companies other than those of the closed-end type' means investment companies[67] whose object is the collective investment of capital provided by the public, and which operate on the principle of risk spreading, and the shares of which are, at the holders' request, repurchased or redeemed, directly or indirectly, out of those companies' assets.

Central Banks may be excluded from the scope of this Directive by the Member States. According to Article 2, the Member States will make sure that, the companies publish half-yearly reports on their activities and profits and losses during the first six months of each financial year. According to Article 3, the Member States may subject companies to obligations more stringent than those provided for by this Directive or to additional obligations, meaning that they apply generally to all companies or to all companies of a given category[68].

1.2.5.1.1.1. PUBLICATION AND CONTENTS OF THE HALF YEARLY REPORT

According to Article 4, the half-yearly report should be published within four months of the end of the relevant six month period, but in exceptional cases, the competent authorities will be permitted to make longer the time limit for publication.

According to Article 5, the half-yearly report must be consisting of figures and explanatory statement related to the company's activities and profits losses during the relevant six month time

---

[65] Commission Of The European Communities,op.cit., pp.165.

[66] Mutual funds are structured in two ways. The more common structure is an open-end fund, from which shares can be redeemed at any time at a price that is tied to the asset value of the fund. Mutual funds also can be structured as a closed-end fund, in which a fixed number of nonredeemable shares are sold at an initial offering and are then traded in the over-the-counter market like a common stock. The market price of these shares fluctuates with the value of the assets held by the fund. In contrast to the open-end fund, however, the price of the shares may be above or below the value of the assets held by the fund, depending on factors such as the liquidity of the shares or the quality of the management (Mishkin, Frederic S., 'The Economics of Money, Banking, and Financial Markets', Harper Collins College Publishers, 4.ed., 1995).

[67] ibid.

[68] ibid.

interval. The figures must be presented in table form and should indicate at least the net turnover, and the profit or loss before or after deduction of tax.

In some instances, the Member States may allow the competent authorities to authorize companies to supply estimated figures for profits and losses, provided that the shares of each such company are listed officially in only one Member State. This situation must be announced by the company in its report and must not mislead investors. Where the company has paid or plans to pay an interim dividend, the figures must show the profit or loss after tax for the six month period and the interim dividend paid or planned[69].

Each figure must be shown together with the figure for the corresponding period in the previous financial year. The explanatory statement must include any important information enabling investors to make an informed assessment of the trend of the company's activities and profits or losses together with an explanation of any special factor which has influenced those activities and those profits or losses during the period under consideration. The explanatory statement should also enable a comparison to be made with the corresponding period of the preceding financial year. It must also, if possible, indicate the company's likely future development in the current financial year[70].

According to Article 6, if a company publishes consolidated accounts it can choose among consolidated or unconsolidated forms when publishing its half-yearly report. However, the Member States may allow the competent authorities, it may be required from the company to publish such information.

According to Article 7, the half-yearly report must be published in the Member State or Member States where the shares are admitted to official listing. A half-yearly report must be written in the official language and in the Member State concerned, selected language must be customary in the sphere of finance and accepted by the competent authorities.

---

[69] ibid.
[70] ibid.

The company must send a copy of its half-yearly report at the same time to the competent authorities of each Member State in which its shares are admitted to official listing. It must do so not later then the time when the half-yearly report is published for the first time in a Member State[71].

According to Article 8, if the accounting information has been audited by the official auditor of the accountants of the company, that auditor's report and any qualifications he may have must be included in full.

1.2.5.1.1.2. OTHER PROVISIONS

According to Article 9, Member States can appoint one or more competent authorities and must inform the Commission of the appointment about such authorities and give details of any allocation of powers among them. Member States must also make sure that this Directive is applied. The Member States should ensure that the competent authorities have the necessary powers to do their job properly.

Where particular requirements of this Directive are not suitable to a company's activities or situation, the competent authorities should ensure that suitable applications are made to such requirements. The competent authorities may authorize the exclusion from the half-yearly report of certain information, if they believe that disclosure of such information would be against to the public interest or may seriously destroy the company. For the correctness and relevance of the facts, on which any application for such exemption is based, the company or its representatives will be responsible[72].

According to Article 10, The competent authorities must cooperate whenever necessary for the purpose of carrying our their duties and will share any information needed for that purpose.
When a half-yearly report has to be published in more than one Member State, the competent authorities of these Member States must use their best endeavors to accept as a single text. This text should meet the requirements of the Member State in which the company's shares were

[71] ibid.
[72] ibid.

admitted to official listing for the first time or it should be the one that mostly closely approximates to that text. In cases of simultaneous admission to official listing on two or more stock exchanges situated or operating in different Member States, the competent authorities of the Member States should use their best endeavors to accept as a single text, the text of the report which meets the requirements of the Member State in which the company's head office is situated. If the company's head office is located in a non-member country, the competent authorities of the Member States concerned shall use their best endeavors to accept a single version of the report.

2. THE REGULATION OF FINANCIAL REPORTING

The major issue in the preparation of financial statements for public corporations is whether financial reporting rules upon which those statements rely need to be determined by a rule-making body because of 'market failure'. The advocates of a 'free market' system say that the best long run regulator is the market itself, so it is the best judge of when and under what circumstances diversity or uniformity in financial reporting is required. The hardest part for the policymaker is to determine whether an existing lack of voluntary disclosure or the presence of several alternative measuring methods is caused by 'market failure' or whether it is attributable to an efficient cost/benefit evaluation by the market.[73]

The reason behind not allowing the market to determine the choice of information needed is ascribed to the 'free rider' problem. Here whereby it is presumed that the benefits of financial accounting information cannot be confined to those who pay for it because a free market in financial information would be expected to result in less than optimal social demand.[74] This is merely one case in the classic public good analysis where in the absence of collective action, there is an under-production of the public good.[75]

---

[73]Horwitz, op. cit.,pp.5.

[74]Rosen, Harvey S.,'Public Finance', 3.ed., Richard D. Irwin,Inc., 1992, pp.75.

[75]The incentive to let other people pay while you enjoy the benefits is known as the free rider problem. Where there are public goods, 'any one person can hope to snatch some selfish benefit in a way not possible under the self-policing competitive pricing of private goods' (Samuelson, 1955, p.389). Hence, there is a good chance that the market will fall short of providing the efficient amount of the public good. Some suggest that the free rider problem necessarily leads to inefficient levels of nonexcludable public goods; therefore, government provision of such public goods is required for economic efficiency. The argument is that the government can somehow find out everyone's true preferences, and then, using

Arriving that conclusion, however, does not considers the strong incentives in the competitive capital markets for the demand and supply of information. On the supply side, incentives exist for firms to provide relevant and reliable information, and on the demand side investors can reflect their preferences for the quantity and quality of information by holding the shares of firms that satisfy their needs. Each firm will disclose and measure to the extend that such behavior reflects the preferences of its investors in equilibrium. Assuming that the cost of shifting their portfolios of securities is less than the cost of adjusting the information disclosed, those investors whose preferences for either the amount of disclosure or the use of particular measurement rules, or both, are unsatisfied can shift their position in securities. But, in the case of mandated disclosure and measurement rules, if the particular set of mandated rules does not fit with the investor's preferences, then information adjustment costs may be carried even when these exceed shifting costs, since the investor's choice of satisfying his preferences by changing portfolios is no longer possible[76].

The presence of disclosure requirements means that 'market failure' exists because amount of information supplied is not sufficient. If measurement considered, however, some argue that if the appropriate amount of information is supplied (disclosed) to investors, then, in an efficient capital market, they can adjust that information using the set of measurement techniques that is appropriate for their preferences. According to this view, measurement regulation is not important, 'market failure' does not apply, and there is no need to mandate uniform rules[77].

The theory of adverse selection[78] and the asymmetry of information between the buyer and the seller (in this case the preparer and user of financial information) may provide hints about the need for measurement rules. Here, uniformity of measurement is required because management as

---

its coercive power, force everybody to pay for public goods. If all this is possible, the government can avoid the free rider problem and ensure that public goods are provided at appropriate levels.

[76] Horwitz, op.cit., pp.6.

[77] ibid.

[78] Adverse selection is the situation that occurs when the people who are most likely to receive benefits from a certain type of insurance are the ones who are most likely to purchase it. Asymmetric information is the situation in which managers have different (better) information about their firm's prospects than do investors.

has more information about its firm than the user of the information and therefore it has an opportunity to select among the measurement rules which may mislead the user[79].

But adverse selection does not explain why the capital market needs arrangements to protect the investor. The reliance on experts acts in part as a substitute for a guarantee with respect to other products,. In addition, where uncertainty exists about the return on an investment, the price of that investment will reflects this. When considering financial statements, the auditor serves to help make the statements credible and experts such as underwriters, financial analysts and other sources may be relied on for advice[80].

A less regulated state where a greater number of measurement alternatives exists may allow management to provide better signals about the future of the firm. It has been argued that the existence of an efficient capital market and a managerial labor market, influencing lifetime earnings through reputation, provides a tool to discipline managers to use measurement methods which provide the most useful information concerning expected earnings of the firm. If there is no restriction on entry to managerial positions, we should guess that the incremental cost of using an alternative would be equal to its perceived benefits[81].

Even if one is willing to admit that the need for regulation is likely somewhere between the place of total regulation of financial reporting with no management choice and a place characterized by a completely free market for information. The movement toward more and more regulation in disclosure and measurement does not seem to have been based on a paradigm of an ideal mix of mandated regulation and market regulation appears to have been a part of a trend. That trend is toward greater corporate accountability. For example, since the creation of the SEC in U.S.A., especially since the nearly 1960s, an important increase in the standardization of practices in the preparation of financial statements is witnessed. That is not a surprise because the SEC was created by the U.S.A. Congress and the promulgation of uniform standards is the basic activity of it[82].

---

[79]Brigham, Eugene F., 'Fundamentals Of Financial Management', 6.ed., The Dryden Press, 1992, pp.476.
[80] Horwitz, op.cit., pp.7.
[81] ibid.
[82] ibid.,pp.8.

2.1. THE SEC, THE FASB IN U.S.A. AND THE RELATIONSHIP BETWEEN THEM

U.S.A. Congress created the SEC in the Securities Exchange Act of 1934 as an independent agency to administer that Act and the Securities Act of 1933[83]. A primary function of the commission is the regulation of disclosure and measurement standards, based largely upon the belief that the failure of securities markets the in 1930s resulted from inappropriate disclosure and large number of measurement methods used by public companies. It was believed, these deficiencies led to a sharp decline in confidence by investors and, in turn, caused to the unprecedented market failure. The primary aim of the acts was the protection of investors, with the assumption that such protection would lead to a more efficient allocation of capital resources[84].

Since its inception, the approach of the Commission has been to transfer its authority, in part, to the private accounting profession to determine the adequate disclosure and measurement rules. This position is made official in ASR 4 in 1938 by the Commission. According to ASR 4, first, the SEC will not accept the financial statements unless they are not prepared according to the generally accepted accounting principles (GAAP), i.e., principles having 'substantial authoritative support'. If such support does not exist then, they are either false or inaccurate despite any disclosures. Second, if the Commission decides that the registrant and the accounting principles used do not have 'substantial authoritative support', the SEC will accept footnotes to the statements (disclosure) in place of changing the statements to the SEC's view point, meaning that the SEC has not previously expressed its opinion on the matter[85].

These two points are essential in order to understand the attitude of the SEC toward accounting (disclosure and measurement) rules. First, the SEC restates its Congress delegated right, to rule against a registrant if it does not follow GAAP as established in the private sector. Second, it has the right to determine its own rules[86].

---

[83]Weston, J. Fred and Eugene F. Brigham, 'Essentials Of Managerial Finance', 10.ed., The Dryden Press, 1992, pp. 718.
[84]Benston, G., 1973, 'Required Disclosure And The Stock Market: An Evaluation Of The Securities And Exchange Act Of 1934', American Economic Review 63:132-55.
[85] Horwitz, op.cit., pp.10.
[86] ibid, pp.11.

In its history, the Commission has looked to the accounting profession for the development and statement of reporting rules. The first attempt to recommend accounting principles is realized by The American Institute of Accountants (AIA), along with the New York Stock Exchange, in the beginning of 1932. It recommended that, the better alternative is to leave every cooperation free to choose its own methods of accounting but to require disclosure of the methods employed and consistency in their application from year to year [87].

Following the ASR 4 of the SEC, a Committee on Accounting Procedure (CAP), which began to issue research bulletins in 1939, was established by American Institute of Certified Public Accountants (AICPA), formerly the AIA. During the period from 1939 to 1953, forty-two bulletins were issued; eight of these were related to terminology. The authority of the Committee was tenuous, because the power of its recommendations relies upon their general acceptability[88]. The AICPA established the Accounting Principles Board (APB) in 1959, because the progress of the CAP was considered to be not sufficiently rapid. The function of this new Board was to formulate the GAAP and to reduce the amount of alternative financial reporting practices. The APB was to rely on persuasion rather than compulsion in reaching these objectives. The basis of acceptance was to be a demonstration that a recommended procedure was expected to be the best among the other alternatives considered[89].

The APB issued 4 Statements and 31 Opinions during its functioning between 1959 and 1973. It is criticized because of its slowness, for the quality of the Opinions and the research behind them and because the voting members of the Board were all accountants appointed by the AICPA and all working on a part-time basis. As a result, the credibility of the APB was lowered at an early stage in its history when the SEC refused to accept an Opinion and forced the Board to reverse itself. So APB was replaced by the FASB in 1973, composed of 7 full-time, instead of 18 part-time, members[90].

---

[87] ibid, pp.12.
[88] ibid.
[89] ibid.
[90] Meigs, Robert F. and Walter B. Meigs, 'Accounting: The Basis For Business Decisions', Mc Graw-Hill Publishing Company, 8.ed., 1990, pp.492.

Thus, the FASB has been the rule-making body in the private sector which has had the responsibility for setting standards of disclosure and measurement in financial reporting for corporate and noncorporate business firms since 1973[91]. The transfer to the FASB by the SEC of the setting of these standards, encompasses public companies only. Yet the effect of standard setting by the Board and its predecessors has been, and is, a single set of rules which apply to private as well as public companies. Because these standards are part of the set of principles used by auditors in the certification process, they are referred to as 'Generally Accepted Accounting Principles' (GAAP)[92].

The compulsive force behind the FASB's pronouncements has come from the accounting profession's code of ethics and their acceptance by the SEC[93]. In ASR 150, the SEC mentioned its expectation that the private standard setting body would take the leadership in establishing and improving accounting rules[94].

2.1.1. THE TREND TOWARD UNIFORMITY IN MEASUREMENT METHODS

The major objective of the financial reporting regulation has been to increase the amount of uniformity in financial statements, leading to a reduction of discretion by management in the choice of alternative reporting methods and to an increase in the extend of comparability which is assumed to be useful to the investor. In seeking uniformity, it may be that rule-makers tend to concentrate on the substance of the transaction rather than its consequence or purpose[95].

Uniformity of measurement rules has been justified by viewing it as a way of reducing management's ability to select rules advantageous to itself but not necessarily in accordance with investor preferences. Uniformity is intended to eliminate 'wrong' methods of reporting, to increase firms' comparability and, as a result, to improve capital allocation[96]. Uniformity is

---

[91] Horwitz, op.cit., pp. 12.
[92] ibid.
[93] AIMR,' Standards Of Practice Handbook, The Code Of Ethics And The Standards Of Professional Conduct, With Commentary And Interpretation', 6.ed., 1992, pp. 185.
[94] Horwitz, op.cit., pp.13.
[95] ibid, pp.16.
[96] ibid, pp. 17.

sought as a necessary condition for providing improved comparability and credibility (confidence) in financial statements when a comparison will be made among similar entities.

On the other hand, critics have argued that if dissimilar entities are being compared, mandated uniformity may lead to incorrect results. Also, the elimination of reporting alternatives can influence investment-production decisions of some firms and its ability to raise capital. Evidence in support of the later argument is related to the level of real effects of a uniform measurement rule to firms' operating and financial characteristics[97].

It is also suggested that auditors prefer to operate in a tightly structured environment which minimizes judgment and so the risk of legal responsibility and that is the reason for uniformity. An examination of the facts behind the 'uniformity versus flexibility' debate reveals that a major concern has been whether possible legal liabilities would be lower under uniformity than under practices which allow alternatives[98].

The case most often made for uniformity of measurement standards relies on the alleged need to improve comparability of financial data by finding similar and different points of certain characteristics between firms and industries. It can be concluded that, the selection of a particular measurement method has not been made arbitrarily by fiat. Rule making bodies mandate a particular method because of its consideration as to be the best one among the other available alternatives[99].

Even when the single best method is decided on, improved comparability is not an aim that can be reached without any costs, and that increasing comparability may destroy or weaken relevance or reliability.

Furthermore, it has been recognized that uniformity may even adversely affect comparability of information if it conceals real differences between companies. The weak point of such an observation lies in the fact that the meaning of real differences may be inherent in the transaction

---

[97] ibid, pp.18.
[98] ibid.
[99] ibid.

being reported alone, the consequences of the transaction, or, in the characteristics of reporting firms. So, definition of differences is very important[100].

2.2. COMPETING OBJECTIVES IN THE DETERMINATION OF DISCLOSURE AND MEASUREMENT RULES

2.2.1. SIGNALING AND UNIFORMITY

Accounting statements serve for two basic functions which are[101];

1. monitoring of management and,
2. providing information to investors or other interested parties.

The first function is based upon contracts like bonding arrangements, indenture agreements and management compensation plans. Many contracts requiring the measurement of financial restrictions or results as a condition of the continuity of the principal-agent relation express their contractual agreements in terms of historically-based or acquisition costs. For example, if the firm's book value of debt to equity exceeds a ratio specified in the contract, a bond indenture may give the right to the lender to demand immediate payment of principal from the firm. The ratio generally is expressed in terms of accounting values according to GAAP[102].

The information required for actual or potential decisions is information related to the future, so the second function of financial statements is forward-looking. One way of derivation of such information is an extrapolation of measurement data accumulated in the past. Another way, the estimation of future earnings by management is a more direct source of this information. Both functions could be attested to by auditors to the extend that they rely on historic data. Even in a system which did not require the auditing function, it would be likely that it would be done anyway because agency costs would be decreased and the uncertainty surrounding inferences by investors would be minimized[103].

---

[100] ibid, pp.20.
[101] ibid, pp.23.
[102] ibid.
[103] ibid, pp.24.

In some situations, where management have a right to choose among different reporting methods when a single measurement rule has not been mandated, perceived need of the investor may be one of the factors that influence that decision. Management can signal its expectations about short or long-term. It is known that, credibility of the method used and of the information given is formed over time and improved through audit attestation. As a result , management would have to consider the increased benefit from the use of a method signaling its expectations, the cost of the attestation by the auditor, and the cost of the reduction of wealth for both the auditors and the manager if a 'false' signal is provided should be considered when selecting among alternatives and disclosing information[104].

Accordingly, if a management has a right to choose among measurement methods, some managements may choose to undertake certain costs, for example auditing costs, in their expectation that providing the information in that way provides the most appropriate signals about the future prospects. But imposed uniformity does not permit management to evaluate the relationship between the advantages provided by signaling and the costs of auditing[105].

2.2.2. THE USE OF UNIFORMITY IN FINANCIAL MEASUREMENT AND INCOME NORMALIZATION

One may thought that, the use of uniformity in financial measurement prevent income normalization or smoothing, sometimes referred to as a way of manipulation[106]. According to the rule-making bodies, smoothing is practiced by some companies to reduce perceived risk and thus to lower their firms' costs of capital. Consequently, by causing their costs of capital to rise, uniformity is likely to increase the volatility of the earnings streams of these companies. But, it is assumed that, the result will be a more efficient allocation of resources, because the mandated method shows the true risk of the firm. It can be concluded that, the expected benefit of a uniform method, which causes a more volatile earnings stream is that, by providing a better picture of risk, resource allocation will improve. But according to the economic theory, risk of the firms depends

---

[104] ibid.
[105] ibid, pp. 26.
[106] ibid, pp.27.

on uncertainty of its future cash flows. Also, with adequate disclosure, investors, who allocate resources, could adjust the statements of firms on any basis they think as appropriate, and so, resources would not be misallocated in an efficient market[107].

The suggestion that mandated uniformity is needed because it better reflects risk means that measurement standards are rules of conduct meant to restrict economic behavior that is unfair. It is assumed that, the manager operating in a world of nonuniformity, will seek unfair advantage over the investor. The investor, in turn, is assumed to be unable to penalize this kind of activities by actions he might take in the market[108].

But it is possible for the uniformity of measurement rules to force management into focusing short-term performance. Because when the regulatory authorities mandate uniform standard measurements, this may cause a greater volatility of earnings and also they may encourage management to focus on the short-term[109].

2.3. POTENTIAL PROBLEMS FACED WHEN MEASUREMENT RULES IMPOSED ON FIRMS

Management accounting is heavily shaped by external financial reporting and requirements and this prevents the management accountants conducting their proper role in improving the performance of industrial and commercial enterprises[110]. This section explores several reasons for possible firm reaction to imposed measurement rules. Considered factors include agency theory, management compensation schemes, exchange listing requirements, government contract evaluation procedures and inefficient markets and income effects. Each of these is discussed in terms of its effect on a investment, financing and dividend decisions of the firm when measurement rules change[111].

---

[107] ibid.
[108] ibid.
[109] ibid.
[110] Brooks, M.J., 'Financial Accounting Principles And Management Accounting', Journal of Management Accounting, October 1988 (66/9), pp.20.
[111] Horwitz, op.cit.,pp.35.

2.3.1. AGENCY THEORY AND MANDATED RULES

Implicit and explicit contracts exists between providers of outside capital (principals) and the managers (agents). Two kinds of contract changes which may affect the equilibrium position of firms are relevant to changes in measurement rules. Bond indenture agreements have restrictive requirements, most of which are written in terms of GAAP. Most of the firms also have compensation contracts with major managers which include bonus plans that also are defined in accounting terms. Changes in accounting practices, by imposing a different system for measuring key variables, can change the provisions of these contracts and so affect the equilibrium position of the firm[112].

Borrowing and managerial compensation contracts could be arranged in ways that would leave them unaffected by accounting changes, depending only upon GAAP existing at the date of the contract. However, this practice would bring additional costs to the firm because of the need to prepare a different set of reports for each contract written that would be different from the report distributed to the firm's equity holders and the relevant authorities[113].

Because investment and financing decisions of the firm have an immediate effect on the aforementioned monitoring measures, for example, key financial accounting levels and ratios, any change in these measures caused by measurement rules may affect the firm's operating and financial decisions[114].

Equally important, any reduction in earnings brought about by a measurement rule may restrict the dividend decisions and affect the firm's choice of investments. Thus, management may adjust its investment portfolio in a way that its expected earnings stream will be less likely to cause a violation of any covenant[115].

---

[112] ibid, pp. 36.
[113] ibid.
[114] ibid, pp.36.
[115] ibid.

2.3.2. SUPPLIERS, LISTING REQUIREMENTS, AND GOVERNMENT CONTRACT AWARDS

The establishment of constraints on activities of the firm as a means of monitoring the firm in order to prevent wealth losses is a concept that is not limited to the customary relationships which firms have with bondholders and residual claimants. Suppliers, securities exchanges and government agencies also establish similar restrictions to protect their loans, reputations and awards or grants. Because of these reasons, unfavorable changes in the monitoring constraints may affect adversely the ability of a firm to continue to receive or to increase trade credit from its suppliers, to continue to maintain or to seek exchange listing for its securities, or to obtain government contracts. Negative changes in accounting numbers and ratios might weaken a firm's ability to receive government contracts[116].

Government agencies are not wealth maximizers and they differ from the investors and creditors in this respect[117]. In addition, decision makers in agencies are more likely to be risk averse than those in the private sector because the personal awards for successful decisions are not as large nor as immediate. As a result, it would be expected that there is a greater tendency for such decision makers to exhibit functional fixation, for example, to focus on accounting numbers rather than cash flows.

The utilization of financial ratios tend to become an important element in assuring contracting agencies against default by contract proposals. Although such ratios are also utilized by lenders, they are likely not as important because the lender, unlike the contracting agency, can add various constraints to assure performance on the loan, e.g., restrictive covenants, higher interest rates and liens[118].

The utilization of financial ratios is central to the determination of capability by governmental agencies. Thus, the financial analyst is required to examine, among a large number of indicators, such ratios as: total liabilities/net worth, net profit/tangible net worth, net profit/net sales, net

---

[116] ibid, pp.38.
[117] Rosen, op.cit., pp.75.
[118] Horwitz, op.cit., pp.40.

profit/working capital and other ratios where either the net profit or the net worth appears. It can be said that measurement rules may affect the contract evaluation decisions of government agencies[119].

2.3.3. EFFICIENT MARKETS AND INCOME EFFECTS

Efficient market theory says that the securities markets do not react ingeniously to 'cosmetic' changes in accounting numbers but only to real events. Accordingly, measurement changes would not be expected to significantly affect security price distributions except in cases in which they are accompanied by changes in disclosure or in cash flows[120].

The efficient market hypothesis is supported by most of the evidence in the finance and accounting literature. For example, it is possible that security market players may react negatively to lower and more volatile earnings and to higher financial leverage ratios of small firms caused by uniform measurement rules[121].

It can be summarized that, changes in measurement rules may affect management's investment and financing decisions, because of perceived or real market inefficiencies, managerial compensation schemes, restrictions on borrowing arrangements written in terms of GAAP, stock exchange requirements or government contract evaluation procedures. In this respect, measurement rules may have indirect, but important effects on a firm's economic decisions[122].

3. MEASUREMENT AND PRESENTATION OF INVESTMENT PERFORMANCE

3.1. PROVISIONS OF CAPITAL MARKET LAW ABOUT FINANCIAL STATEMENTS, DISCLOSURE, AND INDEPENDENT AUDITING

Issuers and capital market institutions are obliged to prepare financial statements, financial reports and information to be disclosed including the consolidated ones or the ones required by the

---

[119] ibid, pp.41.
[120] ibid.
[121] ibid.
[122] ibid, pp.47.

CMB in compliance with the procedure and principles mandated, Generally Accepted Accounting Principles, definitions and standards. The financial statements which do not confirm with the standards and format required by the CMB cannot be disclosed to the public.

The issuers and capital market institutions are obliged to have the financial statements which are identified by the Board and audited by independent auditing firms. They should also comply with principle of fairly reflection, accuracy and reality of information.

The Board may demand the independent auditing reports at the public offering, the phase of adopting the registered capital system, liquidation, transfer, merger and status changes of Joint Stock Companies. The Board may also demand the independent auditing reports from the capital market institutions which are subject to CML. Independent auditing firms are legally responsible for the losses arising from false and misleading information and thoughts related to the financial statements and reports audited by themselves.

The financial statements and reports and an independent auditing report, in the case of being subject to independent auditing, shall be sent to the Board and disclosed in accordance with the principles and procedure stated by the Board[123]. Firms, whose shares are listed on the stock exchange, should send the financial statements (balance sheet and income statement) and independent auditor reports to the CMB and to the stock exchange in 10 weeks following the end of the fiscal periods[124]. If financial statements are not audited, it should be noted in the public disclosures[125].

According to the CML, the CMB shall make regulations in order to protect small shareholders and enlighten the public. It should also realize control over capital and management of publicly held Joint Stock Companies. Also, members of the Board of Directors, General Managers, and their assistants and shareholders who hold %10 or more of the capital of the Joint Stock Companies, are required to inform the Board.

---

[123] 'Sermaye Piyasası Kanunu', Seri XI, Tebliğ No: 1, Madde: 16.
[124] 'Sermaye Piyasası Kanunu', Seri XI, Tebliğ No: 1, Madde: 48.
[125] 'Sermaye Piyasası Kanunu', Seri XI, Tebliğ No: 1, Madde: 49.

According to the CML, firms should disclose their accounting policies in their financial statements. When preparing financial statements, the rules that must also be complied with by the firms are as follows[126]:

- The accounts, which can affect the decisions of the interested parties, should be shown separately. If an account included in the accounts named 'others', and if this account exceeds 20% of the total of this group or 5% of the total assets, it should be presented separately and placed before the accounts named 'others'.

- Financial statements must be prepared in a way that allows the comparison of two fiscal periods. The information given in a financial statement should be consistent with the information given in the financial statement of the previous period.

- In order for a financial statement to be clear, all information required should be included.

- In order to make financial statements clear, necessary information should be given as supplementary information to the financial statements.

- Firms that comply with at least two of the following criterias has to prepare additional financial statements, which are cost of sales, cash flow, profit appropriation and flow of funds statements, in addition to the balance sheet and income statement: total assets exceeding TL 10 billion, gross income exceeding TL 20 billion, or number of personnel being more than 50 persons.

3.1.1. OTHER PROVISIONS OF THE CAPITAL MARKET LAW OF TURKEY

Public offering of the shares

The CML provides three ways in which Joint Stock Company can perform its first public offering. These are[127];

---

[126] 'Sermaye Piyasası Kanunu', Seri XI, Tebliğ No: 1, Madde: 46.
[127] Erdikler-Eratalar YMM AŞ., op.cit., pp.60.

a) Public offering made on a gradual basis,

b) Capital increase by the Joint-Stock Company and the public offering of the shares representing the increased capital,

c) Public offering of the shares by their existing shareholders.

Public offering of bonds and other negotiable instruments

One of the most important provisions of the Law is contained in Article 13, which sets the basic rules regarding the issuance limits of bonds and other debt securities. Resolution 93/3983, effective from January 27, 1993, subsequently allowed companies to extend these limits by increasing them up to sixfold. The issuance limits for other debt securities classified as bonds and capital market instruments by public and private companies are explained below[128].

Joint-stock companies that make no public offering

Under Article 13, the total of bonds and other capital market instruments issued by such Joint-Stock Companies is fixed by the limits set in the Turkish Commercial Code (i.e. up to the amount of paid-in capital). However, according to the resolution 93/3983 non-publicly held companies may extend these limits by increasing them up to sixfold under some predetermined circumstances[129].

Methods of public offering of capital market instruments

There are three major methods for offering capital market instruments to the public[130]:

a) Demand collection method

Under this method, the demands of the investors for the capital instruments, that will be offered to the public, are collected and the instruments are apportioned for sale among them on that basis. Under the demand collection method, the selling price of the instruments is predetermined or upon receipt of "price offers".

---

[128] ibid.
[129] ibid.
[130] ibid.

b) Sales without demand collection

This method consists of the direct sale of the instruments by the issuers themselves through brokerage institutions at a fixed price and without soliciting demands from investors.

c) Public offering at the stock exchange

Capital market instruments may be sold on the Stock Exchange with the approval of the CMB. However, the following conditions must be fulfilled for a Stock Exchange quotation:

1. The company must have been established for at least 3 years before. If at least 25 percent of the share capital is publicly owned, this period may be shortened to 2 years. And this period may be shortened to 1 year, if 40 percent of the share capital is publicly owned.
2. The stock exchange authorities must ascertain and state that the financial structure of the company is sufficiently secure and sound to support its operations.
3. The company should have reported profit for at least the most recent two consecutive years prior to the date of application.
4. The paid-in capital must be at least TL 250 billion and at least 15 percent of the paid-in capital should be offered to the public. But there are exceptions to this rule. If the paid-in capital of a company is between TL 250 - 500 billion, at least 10 percent of the paid-in capital should be offered to the public. And if the paid-in capital of a company is over TL 500 billion, at least 5 percent of the paid-in capital should be offered to the public. If this exceptions are applied and lower than the 15 percent of the paid-in capital offered to the public, remainder part must be offered in 3 years following the first public offering.
5. The capital market instrument must meet the conditions mandated by the Stock Exchange authorities.
6. The company's financial statements must be audited by an independent audit firm.

Capital market transactions and capital market institutions

The capital market transactions and the capital market institutions are governed by Article 30 of the CML. According to Article 30, the major activities of the capital market are the following[131]:

a) Acting as an venue for the issuance, public offering, and sale of capital market instruments registered by the CMB,

b) Purchase and sale of previously issued capital market instruments,

c) Acting as a mediator in financial futures contracts based on financial indicators, capital market instruments, commodities, and precious metals,

d) Trading of marketable securities through repurchase/resale agreements,

e) Advisory services for investors,

f) Portfolio management and/or administration.

CMB permission is required for brokerage institutions wishing to engage in capital market activities. Types of the investment companies are as follows :

A) Brokerage houses
B)Mutual funds
C) Investment corporations
D) Other institutions

Audit Requirements

In addition to the general audit requirements of the Turkish Commercial Code, the accounts of the capital market companies and the banks must also be audited by authorized professional firms. There is no requirement for other real persons or legal entities to have their accounts audited. In

[131] ibid.

addition, certain special audit reports are prepared by sworn financial advisors on certain tax issues[132].

Audit of companies registered with the CMB

In Turkey; companies whose shares or bonds are quoted on the Stock Exchange are required to publish audited financial statements.

Audit of banks

Since 1987 all banks, including branches of foreign banks, have been required to submit reports on their financial statements prepared by independent auditors to the Turkish Central Bank. This report must be accompanied by the report prepared in accordance with IAS (Central Bank requires application of IAS standards except for IAS 29 for banks in Turkey). These reports must be in a prescribed long-form format and must contain comments on the financial position of the bank, ratio analysis, its internal control system, and other judgmental matters which are not normally contained in the audited financial statements. Those long-form reports are not published. However, some of the banks publish their audited financial statements, which are based on International Accounting Standards, while the others publish only the statutory balance sheet and the income statement together with the statutory auditors' report[133].

Accounting and recording principles for Banks

Banks must record all of their transactions using a Uniform Chart of Accounts. Transactions must be supported with appropriate documentation and should be in a verifiable manner. In addition to maintaining and preparing proper accounts and trial balances, the banks are also required to prepare quarterly a balance sheet and statement of income, information regarding loans and deposits, information regarding available funds and additional reserves, and information regarding foreign currency assets and movements. They regularly report these information to the Surveillance Department of the Turkish Central Bank and/or the General Directorate of Banking and Foreign Exchange of the Undersecretariat of the Treasury[134].

---

[132] ibid.
[133] ibid,pp. 47.
[134] ibid, pp.48.

As a general principle, regular audits of banks are performed by Bank Sworn Auditors who are assigned by the Undersecretariat of the Treasury. If and when it is necessary; the sworn auditors are authorized to submit opinions regarding the imposition of administrative or penal measures against a bank's managers[135].

The Banking Law also contains provisions concerning offshore banking, announcements and advertisements, and penalties that are applicable to various actions. Some provisions of the Banking Law are not applicable to investment banks[136].

The Turkish banking system is currently undergoing a major restructuring as part of an effort to harmonize itself to the European Community Law. Harmonization of the accounting methods and principles currently has the highest priority.

In 1994, the banking sector was unable to maintain its previous successful performance. So long as the rate of inflation exceeded the rate of devaluation, as it did for several years up to 1993, banks earned significant profits simply by keeping an open foreign exchange position. However, as a consequence of the devaluations before and after the April 5, 1994 resolutions, they suffered substantial losses. In order to cover such losses, banks have attempted to close their foreign exchange positions rapidly and they moved to a positive exchange rate position. Significant increases in interest rates also brought the problem of nonperforming loans[137].

In the face of these and similar difficulties, the Undersecretariat of Treasury adopted a series of measures to deal with the problems that banks experienced in 1994, a year in which three banks had to be liquidated and two changed hands.

Turkish banks are now fully able to handle all transactions in their local currency and foreign exchange. Thanks to highly-sophisticated communications and computer networks, they offer complete range of services from personal banking to corporate finance and from stock market deals to swap forward markets.

---

[135] ibid.
[136] ibid, pp.49.
[137] ibid.

3.2. REPORT OF THE FAF COMMITTEE FOR PERFORMANCE PRESENTATION STANDARDS IN U.S.A.

The measurement and presentation of investment performance is full of inconsistency. Data presented by investment managers to potential clients are often less than satisfactory in their basis of calculation and in their indicativeness of results across portfolios of the firm. The lack of a standardized reporting format allows some investment managers to be highly selective in their use of numbers to show their historical record favorably[138].

The Committee for Performance Presentation Standards (CPPS) in U.S.A., established in August 1986, aims to identify a clear set of guidelines that would become a model for use by investment managers and to bring about an awareness and a standardization with regard to performance presentation for the first time in the industry. The Committee prepared a standard format for performance presentation which almost everyone in the industry should be able to follow despite the diversity in clienteles. Their report's thrust is to create composites. It mentions the importance of specifying not only what should be included, but also disclosing any exclusions that have been made in any information being presented[139].

The FAF and Institute of Chartered Financial Analysts (ICFA) co-sponsored a seminar focusing on the CPPS's results, namely 'Performance Measurement: Setting the Standards, Interpreting the Numbers'. This seminar, held on January 24, 1989 in San Francisco, addressed the issues underlying the performance problem and how to cope with the inconsistencies included in the measurement and presentation of investment performance data. The following proceedings given below are the result of that seminar.

The issue of performance measurement and presentation is an important one because it is the report card for everyone who is in the investment business. The problem is misuse of the performance figures. There is a tendency for investment managers to manipulate the data to show

---

[138] The Institute of Chartered Financial Analysts and the Financial Analysts Federation, op.cit., pp.vii.
[139] ibid.

their best results, because there is considerable latitude in how performance is calculated and in how it is presented. This leads to confusion and inconsistency[140].

Investment managers must agree that reporting standards have to be improved. The distortions included in the calculation and presentation of investment data must be addressed. The ensuing guidelines can be determined from the industry or from the outside. According to the CPPS, it is the industry's responsibility to establish and enforce standards[141].

The aim of the FAF's Committee for Performance Presentation Standards was to determine a clear set of guidelines that would become a model for the industry and to bring about an awareness and a standardization with regard to this issue for the first time in the investment management industry[142]. The issues surrounding the presentation of the performance data in the investment industry can be summarized as follows: Performance figures have been misused over the years. There exists nearly no consistency within the industry, which has caused considerable confusion and created an environment in which people are able to distort the data[143].

The CPPS worked to create a code of ethics to accompany their proposed standards[144]. The central aim is to make it more difficult for investment managers and advisors to manipulate the numbers, and thus to insure that clients and prospects are treated more fairly than they have been in the past. Also according to CPPS members, disclosure is the central issue. Investment Managers must disclose what they are doing and how they are deviating from these minimum standards. Disclosure is the free market solution to a regulatory problem[145].

January 12, 1989 dated report of the FAF Committee for Performance Presentation Standards is given below. Claude Rosenberg, Jr., Chairman; R.H. Jeffrey; Robert Kirby; Dean Le Baron, CFA; and, John J. F. Sherrerd,CFA are the members of this Committee who prepared this report:

---

[140] ibid.
[141] ibid.
[142] ibid.
[143] ibid.
[144] AIMR, 'Standards Of Practice Handbook , op. cit., pp. 188.
[145] The Institute of Chartered Financial Analysts and the Financial Analysts Federation, op.cit., pp.vii.

Report of the FAF Committee for Performance Presentation Standards[146]

The FAF has endorsed the standards below for performance presentation of investment management. Up to now, this very important subject has been given insufficient attention and as a result, investment advisors have been allowed to follow their own standards, which have been varied, uneven, and, sometimes, outright irresponsible and dishonest. If the investing public is to be treated fairly, and if the investment management industry is to represent the highest ethical and moral standards, a fair and understandable policy should be followed[147].

The philosophy of these standards is the need for full disclosure of investment performance data to clients and prospective clients. Certain statistics and presentation data have been required; but the main theme is that investment managers may present any reasonable statistics provided that their derivation, and particularly any exclusions therefrom, are highlighted and made clear[148].

These standards applies to 'investment managers', which includes all registered investment advisors, but the standards also apply to other organizations and individuals, such as[149];

- Stockbrokers acting as 'portfolio managers' for clients, especially those who charge separate fees from normal commissions for their investment management services.

- Mutual funds, where certain regulatory presentation practices can be deceptive, but which exist under different jurisdictions.

- Consultants, for whom it is recommended that similar standards be set by a separate FAF committee.

---

[146] ibid, pp.6-10.
[147] ibid.
[148] ibid.
[149] ibid.

These FAF guidelines concentrate on the quantitative- on a complete, accurate, and fair presentation of investment performance data, while clients and prospective clients are encouraged to make extensive qualitative judgments of investment managers[150].

Time-weighted performance calculation is an imposed methodology, since it represents the only practical method for comparing investment manager results over time. Total return, including income and capital appreciation, is also compulsory. Results should be presented before the fees so long as the investment manager's fee schedule is included with performance presentation in order to allow for the most efficient judgment of investment manager efficiency and client investment returns[151].

Also, managers and new clients should agree on the starting date for performance calculation. This starting date should be part of the Management Agreement and calculations should comply with such agreed-to date. Since because of the legal problems, delay of receipt of funds, etc., the precise starting date for managed funds is not always definite. It is recommended that a specified period, for example 30 days after funds have become available for investment be set as inception for performance calculation. Again, dependent on investment manager style or client preference, the time period will vary from investment manager to investment manager, but agreement in advance between investment manager and new client eliminates potential confusion and sets a consistent standard[152].

Although monthly valuation is the preferred frequency, portfolios must be valued at least quarterly. The time-weighted return formula, which minimizes the effect of contributions and withdrawals, must be used. The preferred method is daily accounting for contributions and withdrawals. When a contribution or withdrawal is significant in relation to the latest calculation of market value, a portfolio is best revalued on the date of contribution or withdrawal in order to decrease possible distortion. Investment income must be included on a full accrual basis as opposed to cash basis[153].

---

[150] ibid.
[151] ibid.
[152] ibid.
[153] ibid.

Performance results for any one asset class, like equities, should include cash equivalents and any other securities, for example, convertible securities in an equity portfolio, held by the investment manager in place of that asset. If investment managers present performance results for any particular asset class excluding cash or other securities used by the investment manager in place of the asset class, performance with cash and other securities must be presented along with a statement that results so presented that they comply with the FAF standards[154]. For all periods covered in presentation, compound annualized performance returns should be presented. And also, exclusions from account performance calculations and presentation should be presented clearly[155].

Complete information on inclusions and exclusions of data should be presented, as in the attached Tables 1 and 2. Investment Managers must present the percentages of their inclusions as well as exclusions to prospects.

With both equity and fixed-income assets, balanced accounts should be separated into two distinct equity and fixed-income categories. While investment managers may be able to provide sufficient risk and volatility information on each investment class to allow clients to make a reasonable judgment of results as if cash had been included, the information content from the separation of balanced portfolios into distinct asset classes is too valuable to leave to investment manager choice[156].

The performance results from balanced accounts should include the following[157]:

- Equities, including cash or substitute securities created for potential investment in equities.
- Fixed-income, including cash or substitute securities created for potential investment in fixed-income.
- And lastly, total account.

---

[154] ibid.
[155] ibid, pp.7.
[156] ibid.
[157] ibid.

First and second results should be compared against their respective, comparable indexes, as if they were separate equity and fixed-income accounts.

The most significant performance criterion is still the combined, total account results, although separating the parts of a balanced accounts as recommended provides valuable insights into the capabilities of investment managers in each distinct asset class[158].

Results for the total account are best compared against equity and fixed-income proportions that reflect client objectives or guidelines and these proportions should be agreed on by client and investment manager. Comparative performance should then be calculated. For example, assume, a client and an investment manager have agreed to a balanced account risk posture of 60 percent equities and 40 percent fixed-income. The comparative indexes used for equities should be weighted at 60 percent, while the appropriate fixed-income indexes should be weighted at 40 percent, producing a number against which the total account performance return should be compared. In addition to the actual results, performance for accounts utilizing leverage should be calculated and presented as if they had been made for all-cash, that is with no leverage[159].

Investment Managers should explain, in the beginning, any indexes used for performance comparisons to clients. Comparisons with specific measures, for example real returns adjusted for inflation, riskless returns from T-Bills, etc., may be used so long as the standards on other factors are followed[160].

Unless investment manager and client agree in advance to their inclusion in fixed-income, convertible securities should normally be included in equity performance. If convertibles are subsequently shifted from equity segments to fixed-income, or vice. versa, clients should be informed at the time of such shifting[161].

---

[158] ibid, pp.8.
[159] ibid.
[160] ibid.
[161] ibid.

All investment managers should construct and present accurate composites of investment performance and rules for such composites include[162];

- Investment Managers must compile and present such results for as long a period of time as accurate accounting can be accomplished being no less than 10 years and if possible and up to 20 if practical.

- Investment Management organizations performing in the industry for less than 20 years should include results from the very first full calendar year since their inception.

- Unless specific requests are for different periods, each and every year of such results should be presented to prospective clients.

- Results presented to client prospects should be presented both for individual years and cumulative periods, as shown in attached Table 1.

- All client accounts should be included for whatever period such accounts were under management and portions of period under management. Investment Managers choosing inclusion of portions is prohibited.

- Clients' accounts that are no longer under management should be included in composite(s). Survivor, as they are so called, performance results are to be avoided.

- Changes in the organization of the investment manager firm should not lead to an altering of composite results. Results achieved by an organization are the responsibility of the organization and changes in personnel do not constitute a justifiable reason to alter composite performance results.

- Where valid reasons exist for doing so, investment managers are encouraged to construct separate composites. A differentiation between taxable versus nontaxable accounts; fully

[162] ibid.

discretionary versus non fully discretionary; and other categories which include varied investment styles, controls, or risks constitute valid reasons for separate composites. As indicated before, however, investment managers should list all of their composites, with performance figures and other pertinent information on each, whenever performance results are presented. All exclusions from any presentation of performance results should be stated clearly.

- Composite performance calculation and presentation must be weighted by account sizes. A median of unweighted results can also be presented, but this should be together with results weighted by account size.

The number of client relationships included in each composite(s), the total size of the composite for the beginning and end of each year, the weighted average size of accounts constituting the composite, the weighted average size of accounts constituting the composite, the weighted average size of accounts constituting the composite, and information on all excluded assets from any composite presentation should be clearly presented by the investment managers[163].

Fixed-income and equity portions of balanced accounts should be included in their respective equity and fixed-income composites. Balanced account composites must include only those accounts where the investment manager has discretion over changes from one asset to another. The segregated assets with their respective cash positions should be included only with their like asset composite, if the client has set balanced limits from which the investment manager should not deviate. For example, assume a client gives a manager $6 million for bond management and $4 million for stock management, with no changes in mix to be made by investment manager. The $6 million should be added to the investment manager's bond composite and $4 million added to investment manager's stock composite- nothing to be included in investment manager's balanced account composite[164].

Since performance results will be reported to clients along with either actual or average fee information, composite figures should likewise contain sufficient information in order for the

[163] ibid, pp.9.
[164] ibid.

clients to be able to compute performance on both a before and after fee basis. Also, investment managers should indicate typical indexes against which all composites are normally judged by respective clients[165].

Composites should follow the same treatment or returns with and without cash. Also, presentation of risk measurements such as Alpha, Beta, and Standard Deviation for individual account returns within any composite is encouraged. Other related information for use in performance analysis should be added to composite presentations. As an example, investment managers are encouraged to include (for each period) average market capitalization of stocks held, average quality and duration of bond holdings, etc[166].

Table 2 provides a sample recommended format for composite performance presentation to client prospects and consultants. Table 2 should accompany the specific performance results as presented in Table 1.

Audited composite and other performance figures are also encouraged. At least, investment managers presenting performance data must make positive written statement that full disclosure of assets included and excluded has been made and that calculations conform to FAF standards. Any deviations from these standards should be stated specifically[167].

The principles of these FAF performance presentation standards should apply to all individuals and organizations performing investment management functions. Consultants are also encouraged to adopt similar standards and principles in reporting performance data[168].

Lastly, table 3 is a checklist for investment managers and clients- to assure proper conformance to the standards presented above.

---

[165] ibid.
[166] ibid.
[167] ibid.
[168] ibid.

TABLE 1: XYZ Capital Management: Actual and Annualized Equity Performance Versus S&P 500: Tax-Exempt Client Portfolios
Annualized Percentage Returns for N Years Through Year X

Year	Standard Deviation[9]	Actual Return (%)	2 Yrs.	3 Yrs.	4 Yrs.	5 Yrs.	6 Yrs.	7 Yrs.	8 Yrs.	9 Yrs.	10 Yrs.	11 Yrs.	12 Yrs.	13 Yrs.	14 Yrs.	15 Yrs.	16 Yrs.	17 Yrs.
1987	1.2%	10.72	14.30	19.80	15.51	16.07	17.47	14.28	17.58	18.19	17.39	15.06	15.08	15.44	12.75	10.78	13.25	12.25
		5.24	11.75	18.05	15.00	16.47	17.30	13.82	16.00	16.29	15.28	13.03	13.90	15.55	11.88	9.88	10.42	10.65
1986	3.0%	17.99	24.62	17.15	17.44	18.87	14.89	18.59	19.16	18.15	15.51	15.48	15.84	12.91	10.79	11.84	12.35	
		18.67	25.04	18.45	19.46	19.87	15.33	17.62	17.75	16.45	13.84	14.73	16.45	12.41	10.21	10.78	11.00	
1985	1.9%	31.61	16.73	17.26	19.09	14.28	18.70	19.32	18.17	15.23	15.24	15.64	12.50	10.25	11.41	11.99		
		31.75	18.34	19.72	20.18	14.66	17.45	17.61	16.18	13.32	14.34	16.25	11.90	9.59	10.24	10.50		
1984	3.0%	3.54	10.68	15.18	10.31	16.27	17.40	16.36	13.34	13.55	14.17	10.91	8.64	9.99	10.70			
		6.29	14.13	16.55	10.75	14.78	15.42	14.11	11.21	12.55	14.31	10.25	7.92	8.73	9.12			
1983	2.8%	18.32	21.49	12.67	19.69	20.38	18.66	14.80	14.86	15.40	11.67	9.11	10.55	11.27				
		22.55	22.05	12.28	17.01	17.34	15.48	11.92	13.36	15.79	10.66	8.07	8.94	9.34				
1982	6.8%	24.75	9.94	20.15	20.90	18.72	14.24	14.27	15.04	10.95	8.23	9.87	10.70					
		21.54	7.47	15.21	16.07	14.11	10.25	12.10	14.98	9.41	6.72	7.78	8.31					
1981	3.5%	−3.10	17.92	19.65	17.26	12.24	12.74	13.72	9.34	6.54	8.48	9.51						
		−4.97	12.18	14.29	12.32	8.12	10.61	14.06	7.98	5.19	6.49	7.18						
1980	4.4%	43.50	32.96	24.95	16.44	16.20	16.80	11.24	7.81	9.85	10.86							
		32.42	25.35	18.75	11.66	14.02	17.60	9.96	6.53	7.85	8.48							
1979	3.1%	23.19	16.60	8.61	10.23	12.08	6.63	3.49	6.24	7.72								
		18.65	12.46	5.29	9.83	14.83	6.61	3.27	5.12	6.10								
1978	2.4%	10.37	1.98	6.22	9.47	3.59	0.53	4.02	5.93									
		6.59	−0.53	7.04	13.90	4.36	0.91	3.31	4.63									
1977	2.4%	−5.77	4.21	9.17	1.96	−1.33	2.99	5.31										
		−7.17	7.26	16.44	3.80	−0.19	2.78	4.35										
1976	2.5%	15.24	17.51	4.67	−0.19	4.84	7.29											
		23.94	30.42	7.74	1.64	4.89	6.40											
1975	2.9%	19.82	−0.24	−4.85	2.39	5.76												
		37.23	0.46	−4.87	0.60	3.21												
1974	3.0%	−16.94	−15.21	−2.83	2.51													
		−26.46	−20.80	−9.28	−3.89													
1973	2.7%	−13.45	5.10	9.96														
		−14.69	0.75	5.08														
1972	3.2%	27.62	23.94															
		19.00	16.62															
1971	3.1%	20.37																
		14.30																

XYZ CAPITAL MANAGMENT COMPOSITE OF ALL CLIENTS (BOLD)
S&P 500 Index

Characteristic Line[10]: Beta = .89: Annual Alpha = +2.6%; R^2 = 90.3%.

This performance presentation of XYZ Capital Management conforms to the standards set by the Financial Analysts Federation (standards dated , 19). In addition to the information presented herein, such standards include:

1) Returns from all cash reserves and equivalents and/or bonds used by the manager in place of equities are included in performance calculations.
2) Figures include accounts under our management from their respective inception dates, including those clients no longer with the firm.
3) No selective periods of performance have been utilized. Results from all accounts have been continuous from their inception to the present or to the cessation of the client relationship with the firm.
4) The composite calculation has been appropriately weighted for the size of each account.
5) Results are presented before management and related custodial fees. XYZ Capital fee schedule is attached.
6) Convertible securities have been included in these equity results.
7) No alterations of composites as presented here have occurred due to changes in personnel or other reasons at any time.
8) The results have been audited as of 3/31/88 (statement attached).
9) Approximately two-thirds of all portfolios had returns equal to the composite "actual return" +/− one standard deviation.
10) The Characteristic Line is a regression of manager composite performance versus S&P 500 over the full performance history (17 years).

TABLE 2. XYZ Capital Management Equity Account Summary: Tax-Exempt Client Portfolios

Year	Composite Assets ($000) Beg. Yr.	Composite Assets ($000) Yr. End	% Equiv. Equity Assets[9]	% XYZ's Total Equities Managed	# of Clients	Average Account Size ($000)	Median Account Size ($000)
1987	5,506,550	5,881,173	100%	96%	65	80,580	40,813
1986	4,456,012	5,506,550	100	90	62	77,557	28,726
1985	3,463,639	4,464,521	100	92	57	65,655	38,975
1984	3,253,627	3,439,790	100	93	55	52,118	25,926
1983	2,486,902	3,253,627	100	91	56	48,562	20,608
1982	1,840,726	2,480,485	100	89	52	42,042	20,933
1981	1,749,541	1,840,726	100	90	51	31,737	19,262
1980	1,133,875	1,749,541	100	91	45	35,705	26,285
1979	850,993	1,133,875	100	92	42	23,622	12,882
1978	645,561	850,993	100	90	41	18,500	11,268
1977	677,257	645,561	100	85	42	14,345	7,510
1976	540,736	677,257	100	87	44	13,822	7,588
1975	343,959	540,736	100	88	43	11,265	6,058
1974	317,764	343,959	100	90	40	8,000	4,801
1973	179,007	317,764	100	98	33	8,362	6,795
1972	78,626	179,007	100	98	21	7,459	1,997
1971	28,205	78,626	100	98	14	4,914	927

This composite presentation of XYZ Capital Management conforms to the standards set by the Financial Analysts Federation (standards dated ——, 19—). In addition to the information presented herein, such standards include:

1) All cash reserves and equivalents and/or bonds used by the manager in place of equities are included in composite presentations.
2) Figures include accounts under our management from their respective inception dates, including those clients no longer with the firm.
3) No selective periods for presentation have been utilized. Data from all accounts have been continuous from their inception to the present or to the cessation of the client relationship with the firm.
4) The composite calculation has been appropriately weighted for the size of each account.
5) Results are presented before management and related custodial fees. The average fee charged for each period appears in the presentation.
6) Convertible securities have been included in these equity composites.
7) No alterations of composites as presented here have occurred due to changes in personnel or other reasons at any time.
8) The data have been audited as of 3/3'88 (statement attached).
9) Percentage of "equivalent" equity assets means the amount (%) of accounts represented which share very comparable investment guidelines and risks.

TABLE 3. FAF Investment Manager Performance Presentation Standards Checklist

Following is a checklist for investment managers, their clients and prospects, and for consultants, to assure proper conformance to the Financial Analysts Federation "Performance Presentation Standards of January 12, 1989."

I. Performance calculations.

___ A. Performance results have been calculated on a time-weighted basis.

___ B. Returns combine income and current market valuations (thus, presenting so-called total returns).

___ C. Manager fee levels have been disclosed along with performance records so that after-fee results can be measured.

___ D. Performance results of broad security classes such as equities or fixed-income have been included with cash or substitute securities included. If cash has been excluded from the calculations, returns with cash have also been presented, along with the statement that FAF standards consider performance with cash as most representative of managerial results and most representative for comparisons with other managers.

___ E. All exclusions from performance calculations and presentation by manager have been disclosed.

___ F. The method of linking interim performance results (daily, monthly, quarterly) has been explained. (FAF standard is for monthly linking.)

___ G. Balanced account performance.

- ___ 1. Manager has assigned cash and substitute securities to the specific asset category to which it belongs, thereby allowing a clear division of the performance record for each asset managed.
- ___ 2. If cash and substitute securities are not assigned to a separate asset, comparisons should not be made against other managers' performance figures for assets where cash returns have been included.
- ___ 3. Manager has supplied information on risk, volatility, and/or other measures which allow for reasonable performance evaluation.

___ H. Convertible securities have been consistently assigned to either equities or fixed-income, and have not been shifted without notice being given to clients concurrent or prior to such shift.

___ I. Managers have provided the indexes against which their submitted performance records have normally been compared.

___ J. If managers' assets have been leveraged, and performance returns calculated on this basis, results on an all-cash (unleveraged) basis have been provided.

II. Investment manager composites of performance results.

___ A. Manager has submitted a composite of all accounts managed for each period submitted; the composite includes results from any and all accounts no longer clients of the firm.

___ B. If a manager has separate composites, all have been submitted. A prospect should be able to account for the performance of all the manager's assets managed.

___ C. Composites are not "survivors only" compilations; they include results of all accounts ever managed, including those of clients no longer with the firm.

___ D. All performance results contained in the composite include cash and substitutable securities, as per I.D. above.

___ E. All individual years and cumulative performance results for all periods have been supplied. The composite covers every year of the past 10 years, along with longer-term results if the manager has been in the business this long.

___ F. Compound annualized returns have also been provided for all periods.

___ G. A clear statement from manager indicates that no selectivity of account results for partial periods exists.

___ H. Composite or other data have not been altered for reasons of personnel changes or any other reasons.

3.3. PERFORMANCE BASICS

3.3.1. HISTORY OF PERFORMANCE STANDARDS

Indexes were developed and presented in the 19th century for the first time. The best-known index is the Dow Jones Industrial Average, which is simply the sum of the 30 stocks it includes times a factor that adjusts for changes in the stocks, i.e., stock splits. The index concept is crucial to performance measurement. It can be concluded that, this early work on indexes provided some of the foundation for performance measurement[169].

In the 20th century, the idea of the market-weighted indexes is introduced by Alfred Cowles. He took a pro rata share, instead of taking just one share from, say, 30 companies, so the large companies would be presented by a greater number of shares. As a result, the value of the index is the sum of all shares scaled proportionately. The fore-runners of the S&P indexes were the Cowles' indexes. He also got the compounding right and his work, most of which was done in the 1930s, produced many advancements in the creation of a performance index of a stock portfolio[170].

At nearly the same time, open-end mutual funds were first being developed. The accounting of open-end mutual funds entails using the cash flows to buy extra units. This is also very similar to the present accounting of time-weighted rates of return. Thus, again, one of our major performance measurement concepts was developed quite some time ago.
These concepts were put together by Larry Fisher and James Lorie, who were the founders of the Center for Research in Security Prices at the University of Chicago. They created total return indexes, which included both dividends and capital gains, and created investment triangles of the sort that given in the Table 1 of the report of the FAF committee. The first triangles were theirs that included the total returns of stocks. Fisher and Lorie's study, published in 1965, included the historical results from 1926 throughout 1960[171] and they also correctly compounded the results. These results were published in the Bank Administration Institute study in 1968, which discussed

---

[169] ibid, pp.37.
[170] ibid.
[171] Fisher, Lawrence, 'Outcomes for Random Investments in Common Stocks Listed on the New York Stock Exchange', Journal of Business, April 1965.

how performance should be measured. One of the sections in that report, which was authored by Larry Fisher[172], was on time-weighted rate of return.

The Ford Foundation popularized a third major concept of considering total returns[173] in the late 1960s. The report of the Ford Foundation emphasized the importance of total return and that cash could be raised by realizing capital gains in addition to dividends. If you were trying to keep real capital levels, you could sell capital above the initial amount, adjusted for inflation. Because income is somewhat arbitrary, because of being related to tax laws, the dividend yield might differ substantially from one period to the next. And, as dividends become more or less attractive with regard to taxation, those overall yields might change, while the amount of cash generated by the portfolio does not need to be dependent on those factors[174].

Creating a performance index, compounding returns over time, and measuring total return concepts were combined into the current standard of time-weighted total returns.

3.3.2. THE NEED FOR PERFORMANCE STANDARDS

Clients are rarely presented performance data below average. Of course, people experience bad performance, but only after their money is actually being managed and while their own portfolios may contain these poorer numbers, but other portfolios that are shown to them as prospective clients do not. Why, then, are these ex ante presentations so manipulated?

Dishonesty or misrepresentation may be involved, but some of this distortion may result from honest confusion about what or how to report. As an example, instead of the geometric or compound rate of return, some money managers report the arithmetic mean return, which is always biased upwards. Arithmetic means are rarely presented recently, but they were the norm up through the 1960s[175].

---

[172]Fisher, Lawrence, 'Measuring Rates of Return', Measuring the Investment Performance of Pension Funds for the Purpose of Interfund Comparisons, Bank Administraton Institute, 1968.
[173]The Ford Foundation, 'Managing Education Endowments', New York, 1968.
[174] The Institute of Chartered Financial Analysts and the Financial Analysts Federation, op.cit., pp.38.
[175] ibid.

Another example of the reporting practices, which were misleading is the practice of the mutual fund industry of comparing its total returns with capital gain benchmarks like the Dow Jones Industrial Average or the S&P 500. This practice has recently also been almost completely abandoned. Many such distortions are not malicious, and are self-correcting when investors want to know the more relevant information[176].

Although infrequently caused by unaudited figures or calculation mistakes, the difference between ex ante and ex post results is more frequently caused by selection bias. In many cases, the account selected as representative account shown to the client may not be representative. There is a inclination for managers to present their best accounts or their best funds. When a fund performs poorly, the manager quits marketing it and may even combine it with another fund or rename it. Those types of results are rarely ever supplied[177].

Another area that may be indeterminate is simulated results. Simulated studies are often beneficial and appropriate. The pitfall is that such studies present the historical results of strategies that work, as found after the fact. The client is only presented a particular part of all strategies that might be used with his or her portfolio, because the person who performs the simulation already knows which strategies have worked[178].

When presenting performance numbers, a manager can make a number of selection biases, one of which involves choosing the time interval. One example may be for managers to select a time interval that reflects good performance[179].

As it is mentioned before, a second type of selection bias is account selection. Some amount of turnover and change can be accepted as normal in this industry. Also, sometimes accounts are lost because the performance is not attractive. But excluding the poor-performing accounts does not fully represent the performance of the manager. Another possible source of selection bias

---

[176] ibid.
[177] ibid.
[178] ibid.
[179] ibid.

distortion entails excluding assets, particularly cash. Because cash could have had a very important impact on return, it doubtlessly should be included[180].

It is important for managers to present composite performance numbers in the sprit of avoiding selection bias. Absolutely, this practice helps the sponsor to understand the performance of the average client.

Another important issue is whether management fees should be included in performance calculations. Surely, they need to be provided so that an investor in a fund can get a knowledge of what to expect from performance after fees. After fee performance would depend on the specifics of the fee paid to the manager, when one is evaluating a manager prospectively on the basis of after-fee performance. Fees change with many factors, i.e., account size. This is only one reason why having the fees in the calculation of the composite might not aid a client to understand what his or her performance after the fees would be. The composite should be weighted in proportion to assets under management, because it would be downward-biased in terms of the expected after-fee performance. The lower fees are those paid by the larger funds[181].

Fees rely on factors other than the assets under management. Fees are negotiable to an extend. Fees should clearly be provided on a separate basis to give a fair sense of after-fee performance.

3.3.3. PERFORMANCE PROBLEM

Performance measurement is rather subtle and difficult to undertake in practice, although it seems easy in theory. When considering investment performance, it is important to distinguish among the different objectives that one might have. The difference between the performance measurement and performance evaluation is the first distinction. Performance measurement is just an accounting function which tries to reconcile end-of-period with beginning-of-period values. But, performance evaluation addresses the issues of how measured return was attained, whether it was due to skill or chance, and whether future results will be similar. There are lots of ways in order to measure returns and the method chosen by an individual depends on the specific

[180] ibid.
[181] ibid.

performance evaluation objectives. For example, dollar-weighted rate of return would be appropriate, if the performance of the total fund is being evaluated. That is because it provides the return from the perspective of the owner of the fund. On the other hand, if the decision making of the investment manager is being evaluated, the time-weighted rate of return methodology should be used[182].

It is typical to use some kind of averaging of the returns for the individual time periods, when considering returns over various time periods. Arithmetic average return and the geometric compound rate of return are the two common constructs. The geometric compound rate of return is the experienced rate of return over the full period, because it is the rate that will actually equate the value at the beginning of the first period with the ending value[183].

Either for an investment strategy or for the judgment of a potential manager, performance numbers are generally used to form expectations for future performance. For this application, the arithmetic average return is better than the geometric compound return. In fact, the arithmetic average return is an unbiased prediction for the return of the next period. It is the preferred method in order to select an investment or manager, when the next period is the appropriate performance result. But, if long-term performance anticipation is interested in, the geometric compound return should be considered[184].

Another element of performance are costs. The two elements, that are most subject to controversy are transaction costs and management fees. The management fees will be discussed later. Transaction costs can be important. Generally people use simulated results in discussing investment strategies, but most simulations do not include deductions for transaction costs. Illiquidity and turnover produce high transactions costs with some strategies. The transactions costs are not as important a concern with actual reported returns, because market impact costs are reflected in the prices of the stocks and commissions are subtracted from the price to calculate the net price[185].

---

[182] ibid, pp.31.
[183] ibid.
[184] ibid.
[185] ibid.

3.3.4. MEASURING PERFORMANCE VERSUS MEASURING SKILL

When judging manager skill, it is important to make the distinction between total return and active return, or the return net of a benchmark[186]. Further, the cumulative active return, which shows how the manager performed relative to the benchmark on a cumulative basis, is also used. Logarithmic returns should be used to do this correctly. Logarithmic returns are attractive because they facilitate mathematical compounding and statistical testing. While the cumulative active return cannot be computed just by taking the difference between the cumulative portfolio return and the cumulative benchmark return with the typical geometric compound return, calculation can be done with logarithmic returns[187].

The key dimension of performance evaluation is risk. It is also a key factor in determining a skill of a manager, because a judgment about how skillful a manager is in a particular period cannot be made by looking at return only.

There are two connected statistical measures of skill that will be discussed here, namely the information ratio (the expected annualized active return divided by its standard deviation or risk) and the t-statistic for skill. The t-statistic is computed from the information ratio by dividing it by its standard error. The standard error of the information ratio is one over the square root of the number of years in the period. So, the t-statistic equals the information ratio multiplied by the square root of the number of years. By the help of t-statistic, it is possible to calculate the number of years needed to prove that the performance of the manager was statistically significant. Although performance data play a role in building expectations for the skill of a manager, they are not sufficient. In the process of building these expectations, external evidence also plays an important role. External evidence is just information, external to the performance numbers, about the manager and his organization. The different sources of information should thus be combined to form the final evaluation[188].

---

[186] AIMR, 'Performance Evaluation', op. cit., pp.1.
[187] The Institute of Chartered Financial Analysts and the Financial Analysts Federation, op.cit., pp.32.
[188] ibid.

3.3.5. RETURN METHODOLOGIES

First difference between *time-weighted* and *dollar-weighted rates of return* should be understood. The *dollar-weighted rate of return* is the internal rate of return that equates the beginning contribution of funds and the cash flows that occur along with the ending value of the fund. This measure of return is the dollar-weighted average of subperiod returns, with the dollar weights equal to the sum of the initial contribution and all of the cash flows up to the time of the subperiod return, times the extent of that subperiod. So, it is dollar-weighted[189].

The dollar-weighted return methodology's strengths can be summarized as follows; it is easy to understand and compute, and it gives the true rate of return from the perspective of the owner of the fund. The weakness is that it may cloud the effect of the decisions of the investment manager. That is because the intervening cash flows heavily influence the calculation of this return, and those cash flows are typically external to the decisions of the manager[190].

The *time-weighted rate of return* is the weighted average of the internal rates of return for the subperiods between the cash flows, which is weighted by the extent of those subperiods. One needs not only the time and amount of each cash flow, but also the value of the fund at the time of each cash flow is one problem with the time-weighted rate of return[191].

The strong point of the time-weighted rate of return method is that, in theory, it gives the true measure of return due to the decisions of the manager. That is because of the elimination of the arbitrary effect of the cash flow decisions of the sponsor. It is appearent that, the time-weighted rate of return is much better than the dollar-weighted rate of return for evaluating manager performance. This measure contains income and capital appreciation, and is measured using market values. It is also calculated off a total-return index. The first period is equal to $1.00 times one plus the first period return, if the index is initialized at $1.00. While inflows are used to buy additional units of the index, outflows are used to sell units of index. Dividends are treated as

---

[189] ibid, pp.33.
[190] ibid.
[191] ibid.

an outflow, if they are not reinvested. Thus, what is being tracked is $1.00 invested over time, with reinvestment of the income[192].

By dividing the ending value of the total return index, say $2.00, by the initial value of the index, usually $1.00, the compound rate of return is computed. The result is then adjusted for the period of time. For example, if the index doubled over seven years, the seventh root of that must be taken and get about 10 percent as the geometric mean. It is possible to calculate that rate for any period. Table I of the CPPS report displays geometric means based on that index. Thus, this method includes creating a wealth index and then breaking it into compound rates of return over different periods[193].

However, the time-weighted rate of return method is open to some inaccuracies, i.e., cash flows must be used to buy additional units at the market on the day that they are received. Daily accounting would produce very little or no inaccuracy. when the cash flow comes in. However, the potential for inaccuracy and distortion of the index becomes much greater under longer-period accounting. In fact, daily pricing already done for mutual funds[194].

Although, most of the portfolio managers are familiar with the time-weighted rate or return, other areas of finance (especially corporate finance) tend to use an internal rate of return, or a dollar-weighted rate of return. The dollar-weighted rate of return is the rate which equates the initial contribution of funds plus any additional cash flows put in or taken out over the period, with the ending cash flow. It covers the dollars in the fund and shows what happened to those dollars[195].

The reasoning here is that the time-weighted rate of return is created to measure the money manager. Because the money manager does not have control over when the cash flows come in or out, he is only being criticized on the control he has over the actual money in the fund. When the rate of return is time-weighted, all times are equally weighted. Thus the time-weighted rate of return is the appropriate measure[196].

---

[192] ibid.
[193] ibid.
[194] ibid.
[195] ibid.
[196] ibid.

Because the dollar-weighted rate of return describes what actually happened to the dollars in the funds, it should not be dismissed. For example, given some tendency of some investors to chase the previous year's winners, a fund with small amounts of money might attract a lot of money following a very good year's performance. But this fund may produce only average performance in the following year. In this example, the time-weighted rate of return will look good because it includes a few outstanding years from the past. But the dollar-weighted rate of return may not look good because there are more dollars in the poor-performing year. Here, the dollar-weighted rate of return has value, although this would be supplemental information and it would not be a direct measure of the performance of the money manager[197].

3.3.6. PERFORMANCE BENCHMARKS

Another important performance measurement issue is performance benchmarks. Benchmarks are a key tool for understanding the skill of a manager. Also, the more the benchmark reflects the stated style of a manager, the more correctly performance relative to that benchmark is going to reflect the skill of a manager[198]. Specialized benchmarks are called normal portfolios and they should be carefully built and jointly agreed upon both the manager and the sponsor.

Normal portfolios have three distinct advantages: they portray more closely the style of a manager, they reduce the noise in the appraisal of skill, and they provide a passive alternative to the style of a manager. Managers, who know that their investment philosophy and style lead to natural biases, should reflect those biases in the normal and therefore reduce the noise in the measurement process. This tends to decrease the active risk[199].

There are some reasons why calculating return for a benchmark might be more difficult than it is thought. The first issue is deciding what shares to use and what to do with when shares are added to or taken from the total outstanding. Accruals of dividends and other cash flows is another problem. Also, capital transactions may cause problems. Lastly, the choice of which prices to

---

[197] ibid.
[198] AIMR, 'Performance Reporting for Investment Managers: Applying the AIMR Performance Presentation Standards', 1991, pp. 5.
[199] The Institute of Chartered Financial Analysts and the Financial Analysts Federation, op.cit., pp.34.

use is another problem that cannot be neglected. There can be a large difference in the returns of a benchmark depending on what prices are used[200].

There are three criterias in selecting the appropriate performance benchmarks. Firstly, they should be chosen before the fact and settled by the clients. Here, the money manager knows what the particular targets are, when benchmarks are established in advance and the basis for a fair comparison is also provided. Secondly, the benchmarks should mirror the suitable investment universe in which the manager works. And lastly, certain benchmarks should be identified[201].

3.4. ANOTHER PERSPECTIVE: REPORT OF THE INVESTMENT COUNSEL ASSOCIATION OF AMERICA

Many of the concerns that have been expressed by the FAF Committee for Performance Presentation Standards (CPPS) is shared by the Investment Counsel Association of America (ICAA). They all agree with the thought that standards should be established, although the ICAA has reached different conclusions on some of the particular recommendations.

3.4.1. BACKGROUND ON THE ICAA

The ICAA, which was organized in 1937, consists of 145 member firms. The member firms are principally engaged in giving investment advice to clients on a regular basis. Firms are registered under the Investment Advisors Act of 1940[202].

The ICAA is a voluntary and non-profit organization. Its purpose is to promote public responsibility and competence in this profession. The activities of the association extent from cooperating with federal and state governments in formulating rules and regulations to studying investment analysis and management[203].

---

[200] AIMR, 'Performance Evaluation', op. cit., pp.1.
[201] The Institute of Chartered Financial Analysts and the Financial Analysts Federation, op.cit., pp.34.
[202] ibid, pp.46.
[203] ibid.

For more than 15 years, the problems relating to performance measurement has been addressed by the ICAA. It is also well recognized that quantitative record of a firm represents only a part of its work. It is the part that is used most frequently by potential clients to compare one firm with another in the employment procedure and that is why this part is important. Therefore, great care must be taken to supply prospective clients with a comprehensive, precise, and fair history of the work of a firm. Likewise, composites must be prepared to give potential clients an equal basis on which to evaluate the efforts of different firms[204].

The Standards of Measurement and Use for Investment Performance Data is published by the ICAA in 1972. A second section to the book was added one year later, named 'Distortions of Rates of Returns and Their Causes: A Guide to Applying The Standards of Measurement and Use for Investment Performance Data'[205].

The Board of Governors of ICAA published a memorandum to the membership reiterating the points included in the Standards in November 1988. This step was taken in response to the discussion in the media that focused on visible industry-wide inconsistencies and disclosure problems in the development of composites. The increasing use of auditing firms to review and certify reported returns may be the evidence of increased misuse of investment performance data or deceptive advertising[206].

The problem arises when the generally differing needs and objectives of potential clients require the use of more narrowly defined composites rather than a universe of all accounts. Because account circumstances, characteristics, and objectives differ severely, it is with the construction of these more narrowly defined composites that most of the problems occur. On the one side, the decision to include or exclude accounts in a composite must be left to the judgment of the investment manager because of the number of variables included. This causes efforts to develop specific guidelines to cover every situation futile, and most likely would lead to too many complicated rules and even more problems. On the other hand, this is the area of biggest potential betrayal. Inclusion or exclusion of accounts to improve the record may result in

---

[204] ibid.
[205] ibid.
[206] ibid.

crossing the line between a correct and fair presentation of work and a misrepresentation of the facts. Because the mathematical formula for the time-weighted rate of return is straightforward, in oppose to composite data, individual account data presumably are computed correctly[207].

Given this background, the Board of Governors of ICAA felt enough concern to examine and comment on the recommendations contained in the Standards. The cooperation between the ICAA and CPPS has paid off. Although some differences exist between ICAA's recommendations and those intended by the CPPS, most of those differences are practical in nature, not conceptual. In the remainder part of this section, the recent work done by the ICAA performance measurement committee, highlighting the similar and different conclusions of the two committees, will be summarized.

3.4.2. STANDARDS OF PERFORMANCE MEASUREMENT

Firstly, for use in making comparisons with market indexes and with results of other portfolios, the ICAA agrees with the CPPS that investment results should be computed on a *time-weighted total return* basis. An estimated time-weighted return is acceptable, because the obligation to revalue a portfolio whenever an important cash flow occurs makes it difficult and often impractical to calculate exact time-weighted results[208]. The recommended calculation of the ICAA is shown below. The linked internal rate of return is another widely used method, which is discussed in detail in the 1968 Bank Administration Institute study.[209] When cash flows are weighted similarly, despite of the differences in the two mathematical formulas, the differences in calculated returns for subperiods result in a difference of only about 0.01 percent. Either method of estimating a time-weighted rate of return is acceptable, because any significant differences in returns which do occur when using one method versus the other results from the frequency of data collection rather than from the calculations themselves[210].

---

[207] ibid., pp.47.
[208] AIMR, 'Performance Reporting for Investment Managers', op. cit., pp. 32.
[209] Bank Administration Institute, 'Measuring the Investment Performance of Pension Funds', 1968, p.21.
[210] The Institute of Chartered Financial Analysts and the Financial Analysts Federation, op.cit., pp.47.

Recommended Time-Weighted Rate of Return Calculation by ICAA

$$R = \frac{V^2 - V^1 - C + I}{V^1 + 1/2\ C} \times 100$$

Where V^1 = beginning market value = \$1,000,000
V^2 = ending market value = \$1,200,000 (including reinvested income)
C = net cash flow = \$100,000 (from any source including reinvested income)
I = total measurement period income = \$10,000
R = rate of return

$$R = \frac{\$1,200,000 - \$1,000,000 - \$100,000 + \$10,000}{\$1,000,000 + 1/2\ (\$100,000)} \times 100$$

$$R = \frac{\$110,000}{\$1,050,000} \times 100 = 10.5\%$$

Source: ICAA, The Standards of Measurement and Use for Investment Performance Data, 1988, p.7.

An empirical study of annual errors in estimated time-weighted rates of return using the linked internal method is also included in the Bank Administration Institute report. The annual mean absolute error, using quarterly dating of cash flows and frequency of valuation, was plus or minus 0.51 percent. It dropped to 0.12 percent using monthly data, and dropped more to 0.04 percent using monthly valuations and daily cash flows[211].

The ICAA Standards imply portfolios to be valued at least quarterly. Unless cash flows exceed 10 percent of either the beginning or the ending market value, cash flows are assumed to have occurred halfway during the period[212].

---

[211] ibid.
[212] ibid.

The ICAA specifically recommend that accrual accounting to be used like the CPPS, because accrual accounting avoids the problems with a cash accounting basis. The ICAA also agrees with the CPPS that the selection of indexes for comparative purposes is helpful for presenting relative levels of fulfillment within several market environments, and agrees that the indexes selected should be suitable to the situation. Whether an index represents an appropriate alternative investment is a consideration for selection[213].

At least five years experience must be included in the investment results quoted to third parties. The ICAA recommends including as long a time period as possible in the event that less than five years of investment results are available. The ICAA does not endorse combining a record earned at a firm of prior employment to develop a longer investment record. Here, the objectives of both ICAA and CPPS are the same[214].

The total rate of return should be shown on an annual basis, and on a compound annual basis for multiple time periods[215]. To develop composite returns, average quarterly returns are geometrically linked in order to produce annual returns. Both ICAA and CPPS agreed on these points.

Lastly, investment results should be characterized by both the magnitude achieved and the degree of variability experienced in reaching the return. the ICAA suggests the standard deviation as a suitable minimum supplement to the rate-of-return figures. The ICAA strictly did not include beta and alpha in their Standards, because of a sufficient difference of opinion as to the definition of the market and the frequency and term of data collection required for regression analysis[216].

3.4.3. STANDARDS OF USE

How the performance data should be used is also addressed by the ICAA. According to ICAA, investment results should be covered in the composite of the performance of the manager only if

---

[213] ibid.
[214] ibid.
[215] ibid.
[216] ibid.

the manager operated with effective investment discretion. ICAA differs from the CPPS here. CPPS recommends representation of all-fee based accounts[217].

Both groups agreed on the very important point that, investment results should be presented for all discretionary portfolios within a designated category. The criteria used in account or portfolio selection should be explained, new portfolios should be added after no longer than a three-month period and terminated accounts should stay in the universe. Further, if an important change in investment policy is made during a period, or if one is contemplated, it should also be explained. A possible difference between the two is that, the ICAA is referring to accounts of a certain composite and not to all accounts that a manager manages[218].

Adequate disclosure should be made about the description of the sample presented. Substantiation or a detailed breakdown should be given upon request, if only aggregate or average results are presented. Although there is no minimum number of accounts required to comprise a sample, the number included should be mentioned[219].

Comparison of investment results should be made only for portfolios with alike objectives within rational categories of size. The figures presented should involve the average of the returns, number of accounts, mean, range, and standard deviation of returns, when results of portfolios are displayed in aggregate. If the objectives are the same, there should be little difference in representative returns for large and small portfolios. Therefore, if either a straight average or a weighted average of returns is utilized, there should be small difference between the figures. Here, the ICAA and the CPPS contrast. While the ICAA recommends using a straight average, the CPPS recommends a weighted average[220].

The selection of investment results presented to be related in some reasonable way to the circumstances of those receiving the information is very important. Concerning composites created by third parties or consultants, it is often difficult or impossible to determine what

---

[217] ibid, pp.49.
[218] ibid.
[219] ibid.
[220] ibid.

selection parameters are used. However, care should be taken to secure that portfolios which are involved are relevant to those taking information from a third party[221].

The SEC is also involved in this field. In September 1988, the Division of Investment Management of the SEC issued a response to a 'no action' demand allowing the use of gross, or before-fee, investment results in any communication or presentation to a prospective client that is of a secret and private nature and that is not disclosed via any print, electronic, or other medium. Nevertheless, the advisor must supply the prospective client the written disclosures that, because the performance figures do not mirror the deduction of investment advisory fees, the client's return will be lowered by the advisory fees and other expenses that may incur in the management of its investment advisory account[222]. Lastly, a representative example- a chart, table, graph, or narrative - which demonstrates the effect an investment advisory fee, compounded over a period of years, could have on the total value of a client's portfolio should be presented.

Since the adviser instructs the consultants to give performance data to prospective clients of the adviser only on a one-on-one basis and since the consultant provides the four disclosure points just described above, the SEC's response also permits an investor adviser to supply gross performance figures to investment management consultants[223].

4. PERFORMANCE PRESENTATION STANDARDS IN U.S.A.

Under the auspices of the Financial Analysts Federation, the AIMR Performance Presentation Standards were first introduced in the September/October 1987 issue of the Financial Analysts Journal. Since then, the standards have been reviewed in great detail by members of the industry and, while the underlying principles have remained the same, revised in response to their many comments and recommendations[224].

The AIMR Board of Governors approved the standards and endorsed the establishment of the Performance Presentation Standards Implementation Committee, after joining of the Financial

---

[221] ibid.
[222] AIMR, 'Performance Reporting for Investment Managers',op. cit., pp. 20.
[223] The Institute of Chartered Financial Analysts and the Financial Analysts Federation, op.cit., pp.49.
[224] AIMR,'Performance Presentation Standards', 1993, pp. v.

Analysts Federation and the Institute of Chartered Financial Analysts into the Association for Investment Management and research in 1990. It was the responsibility of this group to review the standards in light of industry feedback[225].

This section summarizes the work of the Implementation Committee and, accordingly, the response of AIMR members and other investment professionals who have embraced the thought of establishing a set of guidelines for the presentation of investment performance. As a result of the work of the Implementation Committee and its subcommittees, the wording of the original standards has been revised and supplementary material added.

The standards have been carefully prepared to satisfy several goals, such as, to improve the service offered to investment management clients, to enhance the professionalism of the industry, and also to bolster the notion of self-regulation. Certain subcommittees have studied issues specific to use of the standards to broadened areas, like international investing, the treatment of portfolios using leverage and/or derivatives, real estate and the management of large numbers of small-sized portfolios[226].

The Performance Presentation Standards Implementation Committee is established as a continuing AIMR committee with the responsibilities of reviewing the standards as the industry grows and changes, providing interpretation and explanation, and expending the principles of the standards as new situations emerge.[227]

4.1. QUALITATIVE CHARACTERISTICS OF FINANCIAL STATEMENTS

It is agreed on that the accounting and the other financial data should have certain characteristics. Two groups of these characteristics under the headings '*relevance*' and '*reliability*' discussed below. Because in many cases the format and content of accounting data require a trade-off between the two, that grouping is suitable. Of course financial analysts prefer information that is both relevant and reliable, but their inclination is towards relevance.[228]

---

[225]ibid.
[226] ibid.
[227]ibid, pp.vii.
[228]AIMR,'Financial Reporting In The 1990s And Beyond', op.cit., pp.33.

4.1.1. RELEVANCE

Ideally, the most pertinent accounting data would be those that reported assets and liabilities in a way that would allow analysts to attribute the future cash flows arising from them individually and collectively. However, the certainty does not exist. If it did, there would be no need for analysis. So, we must spend effort for an accounting model that mirrors the degree of uncertainty that surrounds a specific enterprise. While, some assets, like receivables, are set explicitly at the amounts expected to be received in cash, other assets, like certain types of securities, are stated at market value, implicitly the amount of cash that could be received. And also, while some assets are stated at the amounts paid for them (historic costs), some assets may not appear in the financial statements at all because there is no rational way to report them[229].

Although it is generally agreed on that historic costs are irrelevant to financial decisions and they are sunk costs, there is considerable debate as to whether they should be wholly substituted with more relevant current values. Also, determination of the current values of specific assets is a function of financial analysis, not financial reporting according to some opinions. Nevertheless, it is generally accepted that 'lower of cost or market' methods are neither informative nor useful. These methods are based on the assumption that ,according to the creditors, market value is a good accounting measure when it is lower than historic cost, but not when it is higher. But this assumption can be illogical for financial analysts. The best argument that can be made in favor of lower of cost or market is that, because it shows important information on certain asset impairments, it does disclose market values when they are lower than cost[230].

4.1.2. RELIABILITY: GENERAL

Verifiability and *representational faithfulness* are the two primary components of reliability. The verifiability refers to the probability that different accountants, availing themselves of the same evidence, will draw similar conclusions. The representational faithfulness refers to the

---

[229] ibid.
[230] ibid.

probability that the accounting measure portrays accurately the nature of the object being measured[231].

4.1.2.1. RELIABILITY: VERIFIABILITY

This characteristic is closely related to the function of attest. In order for financial reports to be useful, they must be reliable and the report of the independent auditor is fundamental. But the auditor can approve only that which can be documented or confirmed. This may be one of the reasons for the large amount of detailed guidance provided with current accounting standards. The rules have become more detailed as the standards-setting process has infiltrated areas in which the measurements are less than precise. Also, detailed rules may be thought as necessary to serve the needs of both financial statement preparers and their independent auditors. Verifiability means that two unrelated parties considering the same facts independently will arrive similar conclusions. It can be said that detailed rules are now the only way to inculcate verifiability into measurements that otherwise are subject to honest differences of opinion[232].

Knowledge of its absence is another aspect of verifiability. While most accounting numbers have an appearance of accuracy, other than contemporaneous exchanges involving cash, accounting numbers are set by estimates of diverse degrees of inexactitute. Analysts need to know how inexact those numbers are, and also the degree to which the same economic event or condition could have been reported differently using alternative measurement methods[233].

4.1.2.2. RELIABILITY: REPRESENTATIONAL FAITHFULNESS

Because assets and liabilities are likely future economic benefits and claims against those benefits, users of financial statements demand to see them portrayed accurately. There are two aspects to representing them precisely, which are to select the appropriate attribute to measure and to measure it accurately. Of course, there are too many examples to cite them all, but the one given below may be instructive[234].

---

[231] ibid, pp.34.
[232] ibid, pp.34.
[233] ibid, pp.35.
[234] ibid.

Intangible assets are recorded at cost only when they are purchased from another entity under current accounting practice. The effect is that self-developed intangibles are not recorded or just recorded at the nominal amounts spent to guarantee monopoly rights. Moreover, eventhough their value may decrease in some other pattern or increase, the costs of both purchased and self-developed intangibles are amortized over arbitrary future time spans. Those accounting practices cause significant noncomparability between and among companies. Furthermore, many of the future benefits to be achieved from them are more speculative and conjectural than those to be received from tangible assets[235].

4.1.3. TIMELINESS

As it is mentioned before, financial information is useful only when it is disseminated quickly, fairly and widely, because the absorption of such information by analysts is what makes markets efficient. Recently there has been verbalized criticism of the practice of quarterly financial reporting. It is argued that this practice causes managers of businesses to focus on short-term results and neglect those activities whose worth would be greater over a longer time. Investors have been accused for demanding portfolio managers to account for their quarterly performances and portfolio managers for responding to them[236].

It is unlikely that rational investors will punish a firm for undertaking projects that promise extraordinary long-term payoffs since that firm is willing and able to communicate to those investors its strategy and tactics. Also, business managers themselves generally are compensated or otherwise rewarded for short-term performance, measured either by accounting numbers or by the market performance of the securities of their employer[237].

An accompanying benefit of frequent financial reporting is that it lowers opportunities for trading on privileged information. That is because the longer a company waits to disclose information to the public, the more likely it is that the information will become known sooner to a small and

---

[235] ibid.
[236] ibid, pp.36.
[237] ibid.

selected group that can use it to trade for its own benefit. In addition to timely disclosure, fairness also requires neutrality - presentation of data that are without bias. Investors buy and sell securities and financial reports should inform traders on both sides of a transaction in such a way that neither is favored[238].

4.2. THE REQUIREMENTS AND MANDATORY DISCLOSURES NECESSARY FOR COMPLIANCE WITH THE AIMR PERFORMANCE PRESENTATION STANDARDS AND THE PRACTICES THAT AIMR RECOMMENDS IN U.S.A.

The Performance Presentation Standards are a set of guiding principles designed to encourage full disclosure and fair representation by investment managers in reporting in their investment results. A secondary objective is to secure uniformity in reporting in order for results to be directly comparable among investment managers. Because of this, while some aspects of the standards are compulsory, other aspects are recommended. Of course, every situation cannot be foreseen, so complying with the full disclosure and fair representation intents also means making a conscientious, good-faith effort to present investment results in a manner consistent with the underlying ethical principles of the standards.[239] The requirements and mandatory disclosures necessary for compliance with the AIMR Performance Presentation Standards and the practices that AIMR recommends are summarized below.

Requirements[240]

A manager's presentations must include the following practices in order to be considered in compliance:

- Utilization of total return to calculate performance.
- Utilization of accrual, in contrast to cash, accounting.
- Utilization of time-weighted rates of return, with valuation on at least a quarterly basis and geometric linking of period returns.
- Inclusion of cash and cash equivalents in composite returns.
- Inclusion of all actual, fee-paying, discretionary portfolios in at least one composite.

---

[238] ibid.
[239] AIMR, 'Standards Of Practice Handbook' ,op. cit., pp. 188.
[240] AIMR, 'Performance Presentation Standards' ,op.cit., pp. ix-x.

- No linkage of simulated and model portfolios with actual performance.
- Asset-weighting of composites using beginning-of-period values.
- Addition of new portfolios to a composite after the start of the next performance measurement period or according to reasonable and consistently applied manager guidelines.
- Exclusion of terminated portfolios from a composite for all periods after the last full period they were in place, but inclusion for all periods prior to termination.
- No restatement of composite results following changes in an organization of a firm.
- No portability of portfolio results.
- Deduction from gross performance of all trading costs and embedded fees, such as wrap fees, that cannot be unbundled.
- Presentation of at least a 10-year performance record (or for the period since the firm inception, if shorter).
- Presentation of annual returns for all years.

For International portfolios

- Presentation of subsector, or carve-out, returns as stand-alone composites only as supplementary information, if cash and currency allocation have not been separately managed for each subsector.
- Calculation of the benchmark for any currency overlay portfolio in accordance with the mandate of the portfolio, if the benchmark is not actually the currency return on a published benchmark.

For Real Estate

- Presentation of returns from income and capital appreciation in addition to total return.
- Valuation of real estate portfolios at least quarterly.

Mandatory Disclosures[241]

Performance presentations must exhibit the information below:

- The availability of a complete list and description of the firm's composites.

---

[241] ibid

- The number of portfolios and amount of assets in a composite, and the percentage of the firm's total assets the composite represents.
- Whether balanced portfolio segments are included in single-asset composites, and an explanation of how cash has been allocated among asset segments.
- Whether performance results are calculated gross or net of investment management fees; the manager's fee schedule; and for net results, the average weighted management fee.
- The existence of a minimum asset size below which portfolios are excluded from a composite.
- The use of settlement date rather than trade date valuation.
- Whether leverage has been used in portfolios included in a composite, and the extend of its use.
- The inclusion of any non-fee-paying portfolios in composites.
- If performance results are presented after taxes, the tax rate assumption.

For Historical Records:

- The full record not being in compliance, if that is the case.
- The noncompliance periods, if any.
- A description of how noncompliance periods are out of compliance.

For International Portfolios

- Whether composites and benchmarks are gross or net of withholding taxes on dividends, interest, and capital gains; if net, the assumed tax rate for the benchmark.
- Whether the composite s a subsector of a larger portfolio, and if so, the percentage of the larger portfolio the subsector represents.
- Whether representative portfolios are used in the returns of subsectors shown as supplemental information.
- For composites managed against specific benchmarks, the percentage of the composites invested in countries or regions not included in the benchmark.
- For returns that exclude the effect of currency, whether the returns are presented in local currency, and if so, a statement that the local currency return does not account for interest rate differentials in forward currency exchange rates.

For Real Estate

- The absence of independent appraisals.
- The source of the valuation, and the valuation policy.
- The return formula and accounting policies for such items as capital expenditures, tenant improvements, and leasing commissions.

Recommended Guidelines And Disclosures[242]

AIMR encourages the practices listed below:

- Revaluation of a portfolio whenever cash flows and market action combine to distort performance.
- Use of trade-date accounting.
- Presentation of performance gross of investment management fees in one-on-one situations and before taxes (except for international withholding taxes).
- Consistent treatment of convertible and other hybrid securities across and within composites.
- Provisions of the following additional information:

* External risk measures such as standard deviation of composite returns across time.
* Benchmarks that parallel the risk or investment style that the client portfolio is expected to track.
* Internal risk measures such as dispersion of returns across portfolios in a composite.
* Cumulative returns for all periods.
* Portfolio size range for each composite (unless five or fewer portfolios) and the percentage of total assets managed in the same asset class as represented by the composite.
* If leverage has been used, results on an all-cash (unleveraged) basis, where possible.
* Equal-weighted composites in addition to asset-weighted composites.
* For composite results that include both taxable and tax exempt securities, the percentages of each class in the composite and, where possible, returns for each asset class.

[242]ibid., pp. xii-xiii.

For International Portfolios

- Calculation of returns net of withholding taxes on dividends, interest, and capital gains; disclosure of the percentage of the portfolio for which potential capital gains taxes on unrealized gains have not been subtracted.
- Disclosure of inconsistencies among portfolios in the treatment of exchange rates.
- Disclosure of the range or the average country weights of a composite that is managed against a specific benchmark.
- Creation of separate composites for portfolios that allow currency hedging and those that prohibit currency hedging, unless the manager judges the use of hedging to be immaterial, and creation of separate composites for portfolios managed against hedged benchmarks and those that are managed against unhedged benchmarks.
- For a presentation of portfolios excluding the effect of currency, calculation of the return fully hedged back to the base currency of that portfolio.
- Valuation of currency overlay portfolios whenever there are notified changes in the underlying currency exposures (as a result of a shift in the underlying assets).

4.2.1. REPORTING THE PERFORMANCE OF PORTFOLIOS

The performance of portfolios should be reported using the time-weighted rate of return, as well as total return. The calculation of total return, where there are no cash flows for a period, for example, a month or quarter, is generally direct. The formula for calculating total return is given below[243].

$$R_{TR} = \frac{MVE - MVB}{MVB}$$

Where R_{TR} is the total return;

MVE is the market value of the portfolio at the end of the period, including all income accrued up to the end of the period; and

---

[243]ibid, pp. 19.

MVB is its market value at the beginning of the period, including all income accrued up to the end of the previous period.

This famous formula represents increase (or decrease) in the value of a portfolio, including both capital appreciation and income, as a proportion of the starting market value. This unweighted rate of return (R_{TR}) represents a rational way of presenting the performance of a portfolio over a period with no cash flows neither out of nor into the portfolio. This condition, nevertheless, is often violated in the normal management of the account of a client, because cash flows do occur.

If cash flows occur during the period, they must be used theoretically to buy additional units of the portfolio at the market price on the day they are received. So, the most appropriate approach is to calculate the market value of the portfolio on the date of each cash flow, calculate an interim rate of return for the subperiod according to the total return formula , and then combine the subperiod returns to get the return for the month or quarter. This approach eliminates the effect of each cash flow and methods that use that approach are called time weighted rate of return methods[244].

4.2.1.1. METHODS TO COMPUTE TIME-WEIGHTED RATE OF RETURN: DAILY VALUATION METHOD, MODIFIED DIETZ METHOD AND MODIFIED BAI METHOD

Three methods to compute time-weighted rate of return will be described here. While, the first one is the daily valuation method (or valuation whenever cash flows occur), which is preferred, two other methods result in approximations of the daily valuation method. They are the named as modified Dietz method and the modified Bank Administration Institute (BAI) method[245].

Daily Valuation Method. The formula for valuing the portfolio whenever cash flows occur is:

$R_{DAILY} = (S_1 \times S_2 \times ..... \times S_n) - 1$

[244] ibid.
[245] ibid, pp. vii.

Where S_1, S_2, through S_n are the subperiod indexes for subperiods 1,2, through n.

Note that calculating R_{DAILY} does not require determining the subperiod returns. If desired, the subperiod return, R_i, can be determined from the subperiod index by the formula:

$$R_i = S_i - 1$$

There will always be one more subperiod than there are cash flows in the period. Subperiod 1 extends from the first day of the period up to and including the date of the first cash flow. Subperiod 2 begins the next day and extends to the date of the second cash flow, and so forth. The final subperiod extends from the day after the final cash flow through the last day of the period. Each of the subperiod indexes is calculated using the formula:

$$S_i = \frac{MVE_i}{MVB_i}$$

where MVE_i is the market value of the portfolio at the end of subperiod I, before any cash flows in period I but including accrued income for the period, and
MVB_i is the market value at the end of the previous subperiod (i.e., the beginning of this subperiod), including any cash flows at the end of the previous subperiod and including accrued income.

The main advantage of this method is that it calculates the true time-weighted rate of return. The major shortcoming is that it requires exact valuation of the portfolio on the date of each cash flow, which is not always feasible or practical. Moreover, if all securities are not precisely priced for each subperiod valuation, errors generated in the return calculation utilizing the daily valuation method may be greater than the errors caused by using the approximation methods[246].

Modified Dietz Method. The Dietz method, by assuming a constant rate of return on the portfolio during the period, overcomes the need to know the valuation of the portfolio on the date

[246] ibid, pp.21.

of each cash flow[247]. It is assumed that all cash flows occurred at the mid-point of the period. Each cash flow is weighted by the amount of time it is held in the portfolio in this method. The formula for estimating the time-weighted rate of return using the modified Dietz method, RDIETZ, is given below.

$$R_{DIETZ} = \frac{MVE - MVB - F}{MVB + FW}$$

where MVB is the market value at the beginning of the period, including accrued income from the previous period;
MVE is the market value at the end of the period, including accrued income for the period;
F is the sum of the cash flows within the period (contributions to the portfolio are positive flows, and withdrawals or distributions are negative flows); and
FW is the sum of each cash flow, F_i, multiplied by its weight, W_i.

W_i is the proportion of the total number of days in the period that the cash flow F_i has been in (or out of) the portfolio. The formula for W_i is:

$$W_i = \frac{CD - D_i}{CD}$$

where CD is the total number of days in the period, and
D_i is the number of days since the beginning of the period in which cash flow F_i occurred.

[247] ibid.

The numerator is based on the assumption that the cash flows occur at the end of the day. If cash flows are assumed to occur at the beginning of the day, the numerator would be $CD+1-D_i$. Whichever method is chosen, it is important to be consistent.

The main advantage of the modified Dietz method is that valuation of the portfolio is not required for the date of each cash flow. Its main disadvantage is that it gives a less accurate estimate of the true time-weighted rate of return. Especially, when a combination of the following conditions exists, the estimate suffers most; one or more large cash flows occur, and cash flows occur during periods of high market volatility[248].

Modified BAI Method. The modified BAI method determines the internal rate of return (IRR) for the period. The original BAI method was modified to take into effect the exact timing of each cash flow like the original Dietz method. The IRR is that value of R which satisfies the following equation:

$$MVE = \sum F_i (1 + R)^{W_i}$$

where MVE and W_i are the same as for the modified Dietz method. The cash flows, F_i, are also the same as with the Dietz method, with one important exception; the market value at the start of the period is also treated as a cash flow, that is $MVB = F_0$.

IRR is obtained by selecting values for R and solving the equation until the result equals MVE. For example, if there are three cash flows (including the market value at the start of the period), then there will be three terms in the formula:

$$MV_{END} = F_0 (1+R)^{W_0} + F_1 (1+R)^{W_1} + F_2 (1+R)^{W_2}$$

The first term deals with the first cash flow, F_0, which is the value of the portfolio at the beginning of the period. W_i is the proportion of the period that the cash flow F_i was in (or out) of the portfolio. Because F_0 is in for the whole period, $W_0 = 1$. The larger the value of F_i in the

[248] ibid.

term, the more it will contribute to the total. But the smaller the exponent (i.e., the value of W_i), the less the term will contribute to the sum. This usually means that the first term, with a large F_0 and $W_0 = 1$, will contribute much more than the other terms.

The advantages and disadvantages of the modified BAI method are the same as those of the modified Dietz method, but the modified BAI method has the additional disadvantage of requiring an iterative solution process. This makes BAI less preferable than Dietz when manual calculation is required. Nevertheless, calculator and computer programs are available for solving IRR[249].

4.2.1.2. PERFORMANCE GROSS OR NET OF FEES

The Performance Presentation Standards require that any presentation of performance results show whether the portfolio results were computed before investment management fees or after[250]. The standards recommend that performance be presented gross of management fees. As long as the manager discloses which method is being used and includes a fee schedule, the choice of net versus gross is left to the manager. The manager must also disclose the weighted average fee, when net-of-management-fee composite results are shown.

AIMR favors performance results to be presented gross of management fees, which is because a manager's fee schedule is generally scaled to size of assets. Consequently, performance results after deduction of an average management fee will not be representative of results for a portfolio that is much larger or much smaller than the size of the portfolio represented by the average fee. It is more representative to display results before the deduction of management fees and to provide a fee schedule that represents the fee that would actually be paid by the potential client[251].

Also, presenting performance gross of fees shows the manager's expertise in managing assets without the impact of negotiating skills on the part of the manager or the manager's clients, because fees are sometimes negotiable.

---

[249] ibid, pp.23.
[250] AIMR, Performance Reporting for Investment Managers', op.cit., pp. 14.
[251] AIMR, 'Performance Presentation Standards' ,op.cit., pp. 23.

While portfolio performance is reported gross of management fees versus net of management fees, differences in performance results occur. Examples using three periods, for example 1,2, and 10 years, will illustrate what happens when total return is computed gross of fees and net of fees.

Assume a portfolio that has a constant investment return, gross of fees, of 0.5 percent per month and total management fees of 0.05 percent per month of the market value of the portfolio on the last day of the month. Management fees are deducted from the market value of the portfolio on that day and there are no cash flows during the period.

In this simple situation, the value of the portfolio gross of fees at the end of any month i (GMV_i) is given by the following formula:

$$GMV_i = MV_{START} (1 + R_{GOF})^i$$

where MV_{START} is the market value of the portfolio at the start of the period, and
R_{GOF} is the monthly investment return, gross of fees.

The value of the portfolio net of management fees for any month i (NMV_i) is its value after such fees are deducted. This quantity is given by:

$$NMV_i = NMV_{i-1} (1 + R_{GOF}) (1 - F)$$

where NMV_{i-1} is the market value, less management fees, of the portfolio at the end of the previous month, and
F is the fee rate, expressed as a proportion.

This equation simply implies that the value (net of fees) for the portfolio is last month's net-of-fees value times this month's growth, because fees are related to the market value of the portfolio. This result is multiplied by a factor (1 - F) that reduces it by the amount of this month's management fees.

For the first month of the period then, the net-of-fees market value, NMV_1, is:

$$NMV_1 = MV_{START} (1 + R_{GOF}) (1 - F)$$

The value for the second month of the period, NMV_2, is:

$$\begin{aligned} NMV_2 &= NMV_1 (1 + R_{GOF}) (1 - F) \\ &= [MV_{START} (1 + R_{GOF}) (1 - F)] (1 + R_{GOF}) (1 - F) \\ &= MV_{START} (1 + R_{GOF})^2 (1 - F)^2 \end{aligned}$$

The general formula for computing the market value of our example portfolio, net of fees, for any month i, is:

$$NMV_i = MV_{START} (1 + R_{GOF})^i (1 - F)^i$$

Given these formulas, it is easy to calculate the total return, gross versus net of fees, for any period. Total return for the period ending with month i, assuming no cash flows, is:

$$R_{TOTAL} = \frac{MV_i - MV_{START}}{MV_{START}}$$

where MV_i is NMV_i, depending on whether the calculation is of total return gross or net of fees. In the example, the return before fees, R_{GOF}, is 0.5 percent (0.005). Fee rate, F, is 0.05 percent (0.0005). Using these values, the total returns, gross and net of fees, for 1, 2, and 10 years (i.e., 12, 24, and 120 months) are shown in below table.

Gross-of-Fees versus Net-of-Fees Example[252]

Period	Total Return		Basis Points Differential
	Gross of Fees	Net of Fees	
1 year	6.17%	5.54%	63
2 years	12.72	11.38	134
10 years	81.94	71.39	1,055

It can be concluded from the table that the total return during the first two years is 134 basis points lower when performance is presented net of fees. By the end of the tenth year, this difference has grown to more than 1,000 basis points. Of course, the magnitude of the difference between gross-of-fee and net-of-fee returns will depend on different factors, and the example is intentionally simplified. However, it illustrates the marked difference in total return that the two ways of presenting results can produce. It also shows that, the difference increases due to the compounding effect over time, assuming that other factors such as investment return and fees remain constant.[253]

4.2.1.2.1. NET-OF-FEE CALCULATION

In a net-of-fee calculation, the payments should be included as a withdrawal of capital in F (flows) and in FW (weighted flows), when fees are paid from the corpus of the fund. Also, performance results are lowered by deducting fees as negative income in the numerator[254]. Using the modified Dietz method to illustrate, the net-of-fee return is

$$R = \frac{MVE - MVB - F - Fees}{MVB + FW}$$

[252] AIMR, 'Performance Presentation Standards', op.cit., pp.25.
[253] ibid
[254] ibid, pp.25.

In this example, MVE (which includes accrued income for the period) is lowered by the fees. Fees should be treated the same as any other negative flow or withdrawal, because they have been paid out of the account. That is, F includes the fee payment and the fees now need to be deducted from the numerator to reduce the gross return to a net return. When the fee is paid by an external source, it must be subtracted from only the numerator because it has not lowered MVE nor been included in the calculation of F. But the formula is the same and this calculation has the same impact of reducing investment earnings by the amount of the fee without any cash flow adjustment[255].

4.2.1.3. CASH VERSUS ACCRUAL

Except for the dividends and retroactive performance reporting, the AIMR Performance Presentation Standards require that the interest income to be calculated on an accrual basis. Also, the standards recommend that dividends and retroactive performance to be calculated on an accrual basis[256].

The guiding principle in order to determine what income to report is as follows: Include the income, if this income would have been received when the security actually had been sold at the end of the performance period. For example, dividends are not payable, if the stock was not owned on the ex-dividend date for trade date valuations. On the contrary, most fixed-income securities accrue income on a pro-rata basis and this income is payable at the coupon date or when the security is sold[257].

Interest should be accrued for a security in the portfolio using whatever method is common and suitable for that security. The most often utilized way of accruing interest on a U.S.A. fixed-income security is the 30/360-day count method. This method assumes that each month has 30 days, and it assumes a 360-day year[258]. The formula for calculating the number of days over which interest has accrued, using the 30/360-day count method is as follows:

---

[255] ibid, pp 26.
[256] ibid.
[257] ibid.
[258] ibid.

$360 (Y_2 - Y_1) + 30 (M_2 - M_1) + (D_2 - D_1)$

where Y_1 is the year;
M_1 is the month;
D_1 is the day of the previous coupon date; and
Y_2, M_2, and D_2 are the year, month and day of the settlement date.

In calculating accrued interest over a performance period, Y_2, M_2, and D_2 can mean to the end-of-period date and Y_1, M_1, and D_1 to the end-of-period date of the previous period.

4.2.2. REPORTING THE PERFORMANCE OF COMPOSITES

A composite is made up of a set of individual portfolios or asset classes. The composite return is designed to be a single value that reflects the overall performance of the set. The aim in reporting the returns of composites is to use a method for reporting the composite return that will give the same value attained, if the composite were treated as one main portfolio. That is, the value being calculated is the same value that would be achieved if all of the assets and transactions of the individual portfolios/classes were brought together and the return were computed using the procedures discussed earlier[259].

Four methods may be used to achieve a composite return[260]:

- *The equal-weighted return (simple average).* The equal-weighted return will only meet the aim in the improbable event that the market values of all portfolios are exactly the same or all portfolio returns are identical. On the contrary, the simple average, together with the standard deviation, provides measures of the ability of a manager to obtain consistent returns for all portfolios, regardless of size.

[259] ibid, pp.27.
[260] ibid.

- *The asset-weighted return (market-value-weighted average).* If a composite contains two portfolios, one of which is 10 times the size of the other, the rate of return for the larger portfolio should have more effect on the composite return than the smaller one. The asset-weighted return does this by weighting the contributions to the composite rate of return by the beginning market values of its constituent portfolios. This method will also give the same value just like the composite were treated as one master portfolio.

- *The asset-weighted and cash-flow-weighted return method.* Suppose that one of the two portfolios in a composite doubles in market value as the result of a contribution on the first day of a performance period. Under the asset-weighted approach, this portfolio will be weighted in the composite based only on its beginning market value, but not including the contribution. The asset-weighted and cash-flow weighted approach resolves this problem by including the effect of cash flows in the weighting calculation and also in the market values.

- *The aggregate method.* This method incorporates the composite assets and cash flows to calculate performance like the composite were one portfolio and this method is also acceptable as an asset-weighted approach.

Although equal-weighted returns can be reported in addition, the AIMR Performance Presentation Standards require that the returns of composites be asset-weighted. The asset-weighted and cash-flow-weighted method represents a refinement to the asset-weighted approach and it may be used in place of the straight asset-weighted method[261].

The equal-weighted return is just the simple (unweighted) mean of the individual portfolio returns. The formula for the equal-weighted composite return, C_{EQUAL}, is:

$$C_{EQUAL} = \frac{R_1 + R_2 + \ldots R_n}{n}$$

[261] ibid.

where R_1 is the return for the first portfolio in the composite, and
n is the number of portfolios in the composite.

The asset-weighted composite return, C_{ASSET}, may be calculated using the formula:

$$C_{ASSET} = \frac{\Sigma P_i}{MVB_{TOTAL}}$$

where ΣP_i is the sum of the weighted returns for the portfolios within the composite, and MVB_{TOTAL} is the total market value at the beginning of the period for all the portfolios within the composite. (Note that any portfolios added or terminated during the period should not be included in this calculation.)

Each of these weighted portfolio returns is calculated using the formula:

$$P_i = MVB_i \times R_i$$

where MVB_i is the beginning market value (at the start of the period) for a portfolio, and
R_i is the rate of return for portfolio 'i'.

Or alternatively:

$$C = \frac{\Sigma (MVB_i \times R_i)}{MVB_{TOTAL}}$$

The composite returns must be calculated at least quarterly, while monthly is preferred. If monthly composite returns are calculated, the monthly returns are linked geometrically using this formula:

$$C_{QT} = (1 + C_{MO1})(1 + C_{MO2})(1 + C_{MO3}) - 1$$

where C_{QT} is the composite quarterly return, and

C_{MO1}, C_{MO2}, and C_{MO3} are the composite returns for months 1,2, and 3, respectively.

Similarly, to compute the annual rate of return for composite returns calculated quarterly, use the formula:

$$C_Y = (1 + C_{Q1})(1 + C_{Q2})(1 + C_{Q3})(1 + C_{Q4}) - 1$$

where C_{Q1}, C_{Q2}, C_{Q3}, and C_{Q4} are composite returns for quarters 1, 2, 3, and 4, respectively.

4.2.2.1. VALUATION PERIODS AND WEIGHTING

According to the standards, beginning-of-period market values must be used to weight the portfolio returns in a composite. Because better-performing portfolios would always have a greater weight in the composite return, end-of-period values present a consistent upward bias in performance[262].

If portfolios are valued for each quarter, each portfolio's return is weighted by the beginning-of-quarter market value for the portfolio in computing the quarterly composite. If portfolios are valued for each month and linked to get the quarterly return, the return is calculated using either of the two following approaches given below[263]:

- Compute the size-weighted composite return for each month, and link these monthly returns to obtain the quarterly return. This approach is more precise and so favored.
- Link the (unweighted) monthly returns to obtain the quarterly return for each portfolio and then weight each portfolio using its beginning-of-quarter market value, and compute the asset-weighted composite return.

An even more precise value can be achieved by utilizing the asset- and cash-flow-weighted method.

---

[262] ibid, pp. 29.
[263] ibid.

4.2.2.2. METHODS FOR ALLOCATING CASH

When the segment returns are being presented as indication of ability to manage the segment by itself, the standards mandate that cash be allocated to the segment returns of a multiple-asset portfolio. The standards oblige that cash be allocated in a way that is representative of the intended style of a manager. Characteristics common to an acceptable method are as follows; The method must allow for an ex ante decision to allocate cash, it must meet the tests of being reasonable and representative and it should allow for an audit trail that provides evidence of the cash allocation decision. Several different methods, which are given below, may be used[264].

The *separate portfolios approach* includes simply splitting the multiple-asset funds into separate portfolios based on asset class. The portfolios may be combined for client reporting and may be measured separately for performance aims. Although, this method is conceptually simple, it has a disadvantage that separate portfolios increase the workload involved in portfolio administration by increasing the number of portfolios that must be managed. The approach also means that the money market management function is made more complex by the increased number of portfolios that must be traded[265].

The *multiple cash balances approach* includes maintaining distinct cash balances for the segments within a single multiple-asset portfolio and in this method, the original number of portfolios is maintained. But the extra effort involved in administration differs little from the above approach. That is short-term trading must still be segregated by asset class, and cash transactions have to be entered to move cash from one segment to another. A decision matrix must be created to direct which cash balance will be affected by each of the various transaction types[266].

Finally, the *allocation of cash returns approach* includes the allocation of rates of return rather than the maintenance of actual separate cash balances. Under this approach, cash and equivalents are maintained as a single entity in the multiple-asset portfolio. The rate of return for cash and

---

[264] ibid, pp.30.
[265] ibid.
[266] ibid.

equivalents and for all the asset segments is determined and then the cash and equivalents returns are allocated to the segment returns to create segment-plus-cash returns[267].

This approach has a minimum effect on current management and administration practices. There is no need to segregate short-term trading by asset class, increase the number of portfolios, or develop a decision matrix for the cash effects of trading[268].

The individual money manager should determine the tests of reasonableness and representativeness in the light of a particular investment strategy. The appropriate method for allocating cash returns will be determined on a case-by-case basis.

There are two more methods of allocating cash returns[269]:

- *Predetermined cash allocation mix applied to residual cash.* At the beginning of the reporting period, the manager sets a cash allocation mix, for example 60 percent stocks, 40 percent bonds; remainder cash is allocated correspondingly. This approach is suitable especially for strategies that call for nearly 100 percent investment at all times, which means the effect of residual cash has minimal impact on the single-asset results.

- *Cash allocation based on target asset class percentages determined at the beginning of the period.* Actual asset allocations are compared to the target allocations of the beginning-of-period. If a segment is underinvested with respect to its beginning-of-period target, the differential is drawn from residual cash plus cash equivalents, and the appropriate cash return is applied. While, if a segment is overinvested, no adjustment is required.

Actual asset allocations are compared with the beginning-of period target allocations and if a segment is underinvested relative to its beginning-of-period target, the differential is drawn from residual cash and cash equivalents. If a segment is overinvested relative to its beginning-of-period target, the segment borrows from cash and cash equivalents while the borrowing cost is the cash

---

[267] ibid.
[268] ibid.
[269] ibid.

segment return. Because this borrowing cost is deducted from the single-asset return, there is the possibility of negative cash balance with this approach. It might also mean that the investment strategy uses leverage[270].

Furthermore, actual asset allocations may be compared to the beginning-of period target allocations with the addition of the return weights being adjusted by purchases, sales, contributions, withdrawals and income. According to this method, the target allocations are readjusted to reflect active allocation decisions by the manager all over the period.

At last, borrowing also may occur between segments in addition to the cash segment. If an asset segment is underinvested, assets are allocated to meet the beginning-of-period target, but if residual cash was insufficient, borrowing occurs between the other segments. Instead of utilizing a blended return of segment plus cash and cash equivalents, the manager applies blended returns based on segment returns. Overweighted segments borrow at a segment cost, and underinvested segments are merged with segment returns rather than with the cash return. If bonds are used as equity surrogates, this approach might be representative.

Moreover, the characteristics of ex ante decision making and the provision of an audit trail should be replicated for retroactive cash allocation. Unless a manager can identify a method that accurately represents what the historical cash allocation would have been, retroactive cash allocation should not be attempted.

4.2.3. MEASURES OF RISK AND DISPERSION

To provide a better understanding of risk measures that might be used to meet the recommendations of the standards, several examples, including comments and recommended treatment for performance presentation, are set forth. Both the internal and external risk measures should be considered in presenting performance results. External risk measures judge the riskiness of investment strategies. Measures based on current and historical data like this can be used to estimate the future riskiness of a strategy. Internal risk measures are techniques in order

---

[270] ibid.

to evaluate how consistently a manager performs with respect to individual portfolios within a composite[271].

4.2.3.1. EXTERNAL RISK MEASURES - INVESTMENT STRATEGY RISK: STANDARD DEVIATION, BETA, THE SHARP MEASURE AND THE TREYNOR MEASURE

Because there is a trade-off between risk and return, a manager who earned 15 percent is not necessarily better than the manager who earned 14 percent if the former took more risk than the latter. There are some methods that can be used to measure the riskiness of alternative strategies.

Standard Deviation. Standard deviation of portfolio performance over time (S_P) is a measure of volatility and it indicates how far data spread about their central tendency or mean[272]. The standard deviation of historical data for an asset-weighted composite over time is calculated as follows:

$$S_P = \sqrt{\frac{\Sigma \left[\text{CASSET}i - \text{MEAN (CASSET)}\right]^2}{n}}$$

where CASSETi is the asset-weighted composite return in the *i*th time period, and
n is the number of periods in the study.

In theory, a portfolio that is more volatile than an index or benchmark should get a higher return in order to compensate the extra risk taken. One tends to use the past to project forward, when looking at investment strategy risk. For example, it is logical to assume that a manager's strategy will continue to display the same volatility or risk level in the future as it has historically. Although the measure is subject to time period selection bias, the use of standard deviation in gauging the riskiness of a strategy is consistent with the use of this statistic in measuring historical volatility as a predictor of the riskiness of an asset class[273].

---

[271] ibid, pp.33.
[272] ibid.
[273] ibid.

Beta. Beta can be defined as the average performance volatility with respect to the market[274]. Some clients with a long-term perspective thought that high volatility is not necessarily bad, because it may well be rewarded by excess return over time. But most agree that given two identical sets of returns, they prefer the one that was achieved in a more consistent manner. There are many possible definitions of beta in assessing the ex ante market volatility of a single portfolio at a specific time. However, the beta referred to in the standards pertains to the history of a group of portfolios, not the current holdings.[275]

This expost definition of beta is calculated as the coefficient of a least squares linear regression of composite performance relative to a broad index of market performance. A simple regression for such a characteristic line utilizes absolute returns. A little more complicated but more correct form was proposed by Sharpe[276] as the Capital Asset Pricing Model and by Jensen for portfolios. In this case, the equation is defined in terms of excess returns:

$$Y - Rf = \alpha + \beta (X + Rf)$$

Where Y = manager composite performance;

X = index performance;

α = regression intercept;

β = regression coefficient or slope; and

Rf = the risk free return during the period, usually defined as the 90-day treasury bill return, but a manager might justifiably use a longer maturity.

In either case, the best linear fit of composite performance to the index can be calculated as

$$\beta = \frac{\Sigma (X \times Y)}{\Sigma X^2}$$

---

[274] Jack Clark and Richard W. Taylor, 'Schaum's Outline Series : Theory and Problems of Investment', McGraw-Hill, Inc., 1992, pp.266.

[275] AIMR, 'Performance Presentation Standards', op. cit., pp.34.

[276] Francis, Jack Clark and Richard W. Taylor, 'Schaum's Outline Series : Theory and Problems of Investment', McGraw-Hill, Inc., 1992, pp.263.

$$\alpha = \bar{Y} - \beta \times \bar{X}$$

where $\bar{Y}$ = the average of all months of composite performance (or excess performance adjusted for the risk-free rate); and

$\bar{X}$ = the average of all months of index performance (or excess performance).

The Sharpe Measure. The Sharpe measure (Sm_P) is a ratio defined as the excess return on a portfolio divided by the volatility of the securities[277]. Its formula is as follows:

$$Sm_P = \frac{(\text{Composite Performance} - Rf)}{S_P}$$

where Rf is the risk-free rate of interest, and

S_P is the standard deviation of the portfolio.

The ratio is a measure of reward relative to total volatility. It may be used to help an investor to determine how much risk will maximize his or her utility. A large portfolio of securities should receive some reward for taking volatility (S_P); or else, it would be more logical to have a portfolio of Treasury bills. As a result, the Sharpe measure, which uses total volatility, seems to be most useful when the portfolio being evaluated represents all of the marketable assets of an investor. The Sharpe measure for the portfolio can also be compared to the Sharpe measure for the benchmark[278].

The Treynor Measure. The Treynor measure (Tm_P) is a ratio defined as the excess return on a portfolio divided by the portfolio's average beta[279]. Its formula is as follows:

---

[277] ibid

[278] AIMR, 'Performance Presentation Standards', op.cit., pp.35.

[279] ibid.

Tm_P = (Composite Performance - Rf) / β_P

The reward relative to total systematic volatility, or relative risk can be measured by this ratio. The riskiness of individual securities or a small group of securities may best be described by their comovement with the market (β). As a result, the Treynor measure seems to be especially useful when the investor's portfolio is one of many portfolios included in a large investment fund[280]. The Treynor measure for the portfolio can also be compared to the Treynor measure for the benchmark.

If one recognizes the weaknesses of the primary risk statistics, namely standard deviation and beta, the comparison ratios introduced by Sharpe and Treynor have important implications. It is concluded that no one statistic can consistently capture the riskiness of an asset class or a style of management. The use of a variety of measures with an understanding of their shortcomings will provide the most valuable information[281].

4.2.3.2. COMPOSITES VERSUS BENCHMARKS: INDEXES, MANAGER UNIVERSES AND NORMAL PORTFOLIOS

Benchmarks are used to make comparisons in risk and return. They can include a variety of alternatives such as market indexes, manager universes and normal portfolios[282]. Each type of benchmark has its own advantages and disadvantages. A brief explanation of each will be provided. The risk measures explained above are generally reviewed on a relative basis compared to one or more benchmarks[283].

Indexes. The most frequently used benchmark for an investment strategy is a market index. Indexes are seen as an independent representation of the market and are generally readily available. There is a significant potential for misinterpretation when an index does not accurately

---

[280] Francis,op.cit.,pp.264.
[281] AIMR, 'Performance Presentation Standards', op.cit., pp.36.
[282] AIMR, Performance Reporting for Investment Managers', op. cit., pp. 68.
[283] AIMR, 'Performance Presentation Standards', op.cit., pp.36.

reflect the strategy or universe of securities employed, although indexes are widely utilized and can offer significant insight regarding relative risk. Indexes implicitly assume cost-free transactions, and some assume reinvestment of income[284].

Manager Universes. Consultants collect data on styles of investment managers to create a universe of return data. These universes have the potential to match styles more effectively than do simple indexes, although there are some problems in implementation. The problems involve; different managers conforming to different reporting procedures, completeness and accuracy of data, sample size for specialty strategies, and survivor bias. In spite of the existing problems, universes are still an important part of measuring relative risk and return[285].

Normal Portfolios. A 'normal portfolio' is a specially designed benchmark portfolio that controls for investment strategy and thus provides a bogey for evaluating discretionary investment decisions. Although normal portfolios are not used extensively in the industry recently, they offer a valuable means to judge specific risk. Unfortunately, normal portfolios also suffer from being generally difficult to construct and maintain. However they seem to work better as a specific client's benchmark rather than as a strategy comparison[286].

The individual investment strategy should decide on the best benchmark or combination of benchmarks. Certainly, an index strategy must be compared to the appropriate index. Because there is a large enough population of similar strategies and no simple index available for comparison, a low-price-earnings fund may best be judged against an appropriate manager universe. Because active balanced managers may vary significantly in their approaches, their risk may best be judged against a very specific normal portfolio. The standards heavily recommend the use of consistently applied risk measures appropriate to a given strategy in order to provide a complete picture of performance[287].

---

[284] ibid.
[285] AIMR, 'Performance Evaluation', op. cit., pp.108.
[286] AIMR, 'Performance Presentation Standards', op.cit., pp.37.
[287] ibid.

4.2.3.3. INTERNAL RISK MEASURES: STANDARD DEVIATION, HIGH-LOW AND RANGE, QUARTILE DOLLAR DISPERSION (QDD) AND SAMPLE REPORT

Most of the studies about the riskiness of a management style focuses on the external measures of risk for evaluating a manager's performance on an absolute basis or as compared to a target benchmark. But far less effort has been spent on determining how consistently a manager applies that strategy across portfolios within a composite. Dispersion within a composite is a relevant and valuable piece of information for an investor[288].

Despite the approach to averaging, the use of composites for aggregating results requires some measure to gauge the consistency of those results. Traditionally, the range of returns and standard deviation have been the commonly used methods. These statistics have also advantages and disadvantages. The usage of asset-weighting causes some problems with using traditional standard deviation as a meaningful statistic. An alternative may be the use of a generalized reformulation of standard deviation. This asset-weighted dispersion measure will be discussed later, as well as other measures that may provide insights into the dispersion of results within a composite[289].

Standard Deviation. The most widely accepted measure of dispersion within a composite is standard deviation across equal-weighted portfolios (S_c). The definition is as follows:

$$S_c = \sqrt{\frac{\sum [R_i - \text{MEAN}(R)]^2}{n}}$$

where R_i is the return on the *i*th portfolio, and

n is the number of portfolios.

---

[288] ibid, pp.38.
[289] ibid.

This definition assumes a normally distributed population and so should be applied to an equal-weighted composite.

Tables 1 and 2 below contain examples that illustrate some problems with using equal-weighted composites and 'traditional' standard deviation. The example shows two similar managers, with identical asset-weighted means of 17.5 percent within their respective composites. Manager One has an equal-weighted composite of 12.5 percent, while Manager Two has an equal-weighted composite of 17.5 percent. It can be argued that they should have similar means and dispersion statistics, because each turned $200,000 into $235,000 (10 percent on $100,000 and 25 percent on $100,000) in the same fashion, because both managers have shown an equal level of skill. The example shows the weaknesses inherited in utilizing equal-weighted composites and deviations. These two managers should have the same measure of dispersion; that is, their dollars are equally clustered around their asset-weighted average of 17.5 percent.

Table 1- Equal-Weighted Example[290]

Portfolio	Return	Capitalization	$[R_i - MEAN(R)]^2$
Manager One			
A	10%	$20,000	.000625
B	10	20,000	.000625
C	10	20,000	.000625
D	10	20,000	.000625
E	10	20,000	.000625
F	25	100,000	.015625
Composite Return			12.50%
Standard Deviation			5.59%
Manager Two			
A	10	100,000	.005626
B	25	100,000	.005625
Composite Return			17.50%
Standard Deviation			7.50%

[290]AIMR, 'Performance Presentation Standards', op. cit., pp.39.

Table 2 - Asset-Weighted Example[291]

Portfolio	Return	Capitalization	$w_i (R_i - C_{ASSET})^2$
Manager One			
A	10%	$20,000	(20/200)x(.005625)
B	10	20,000	(20/200)x(.005625)
C	10	20,000	(20/200)x(.005625)
D	10	20,000	(20/200)x(.005625)
E	10	20,000	(20/200)x(.005625)
F	25	100,000	(100/200)x(.005625)
Composite Return			17.50%
Standard Deviation			7.50%
Manager Two			
A	10	100,000	(100/200)x(.005625)
B	25	100,000	(100/200)x(.005625)
Composite Return			17.50%
Standard Deviation			7.50%

To develop a dispersion measure that explains deviation from the asset-weighted composite is relatively straightforward. The formulation begins with the calculation from an asset-weighted mean. The asset-weighted composite return is formulated as follows:

$$C_{ASSET} = \frac{\sum MVB_i \times R_i}{MVB_{TOTAL}}$$

where MVB_i is the market value of the *i*th portfolio in the composite at the beginning of the period, and

R_i is the unweighted return on the *i*th portfolio.

The reformulation of standard deviation to achieve a meaningful statistic to apply to an asset-weighted mean is as follows:

$$\text{Dispersion} = \sqrt{\sum w_i (R_i - C_{ASSET})^2}$$

[291] ibid.

where w_i is the weight of the ith portfolio or (MVB_i / MVB_{TOTAL}).

It is important that an asset-weighted composite does not measure the performance of the average portfolio, but it measures the performance of the average dollar. An asset-weighted composite can be thought as if the performance of one dollar, that dollar been invested in portfolio of every client in proportion to the weight of the client's portfolio within the composite[292].

The traditional standard deviation from an equal-weighted mean is just a special case of standard deviation from an asset-weighted mean. One of the problems with most of the measures of dispersion is that there are no standardized units. Standard deviation of a composite uses percent[293].

While, it is not possible to annualize the standard deviation and the proposed asset-weighted dispersion measure, long-normal, continuously compounded rates of return have standard deviations that can be annualized in a simple fashion. Deviations from asset-weighted or equal weighted means cannot also be annualized. In order to calculate the annual dispersion statistic, annual rate-of-return data is needed. Also, in order to calculate quarterly and monthly dispersion, quarterly and monthly data are required. Although this requirement can be proved algebraically, an intuitive example in Table 3 will show why the deviations cannot be connected. It is assumed in Table 3 that there are no transactions on accounts that begin the year with $1 million. For the year, this manager has zero deviation, yet there has been dispersion along the way, and the numbers themselves are only relevant within their time frame. (The results are nearly same for equal-weighted returns.)

In addition, there is no value in averaging 4 quarters of data for some kind of 'quarterly average', and to take these number and divide them by 4 has no mathematical relevance.

---

[292] ibid, pp.40.
[293] ibid.

Table 3 - Asset-Weighted Deviation Example[294]

Period	Client A	Client B	Asset-Weighted Deviation
Q1	2.00%	0.00%	1.00%
Q2	8.00	0.00	4.00
Q3	-3.00	8.00	5.49
Q4	0.00	-1.06	0.53
Year	6.86	6.86	0.00

High-Low and Range. The simplest and most easily understood measures of dispersion are high-low and range. Their most important advantages are simplicity, ease of calculation, and ease of interpretation. One extreme value could skew the appearance of the data on the downside. The calculation of the high-low and the range of returns, which will be the same for equal-weighted and asset-weighted composites, is not especially rigorous. But combining these measures with other measures, such as the one shown below, increases the value of presenting the high-low and range of returns[295].

Quartile Dollar Dispersion (QDD). High-low and range by themselves are not adequate measures of risk because, like standard deviation, they are prone to extreme values that may skew the picture. It would be helpful to consider alternative measures of dispersion. The example below uses the spread of dollars across quartiles to provide additional insights into the dispersion of returns. It should be noted that, although a portfolio is broken into quartiles, this measure has nothing to do with quartiles for returns shown in manager universes[296].

Using the data in Table 4, the rate of return on different quartiles can be calculated. For example, for the worst-performing 25 percent,

$$QDD = \frac{200{,}000}{250{,}000}(.08) + \frac{50{,}000}{250{,}000}(.09) = 8.2 \text{ percent}$$

[294] ibid, pp.41.
[295] ibid
[296] ibid.

Table 4 - QDD Example: Data[297]

Portfolio	Return	Capitalization
A	8%	$200,000
B	9	200,000
C	10	400,000
D	11	100,000
E	15	100,000

The rate of return on the best performing quartile is

$$QDD = \frac{100,000}{250,000}(.15) + \frac{100,000}{250,000}(.11) + \frac{50,000}{250,000}(.10) = 12.4 \text{ percent}$$

QDD is not prone to the extremes because it covers one fourth of the data in both directions.

Sample Report. Table 5 provides a sample report presenting return and selected risk measures. In addition, a manager should have the choice of supplementing (not substituting) this table with equal-weighted composites and standard deviations from an equal-weighted mean.

Table 5 - Sample Dispersion Report

Period	Asset-Weighted Mean	Highest Performer	QDD1	QDD4	Lowest Performer	Asset-Weighted Dispersion
Year	10.00%	15.00%	12.40%	8.20%	8.00%	1.90%
Q1	4.10	6.00	5.20	3.20	3.00	0.83
Q2	0.50	2.00	1.41	-0.80	-1.00	0.92
Q3	-1.29	0.00	0.24	-2.00	-2.00	0.60
Q4	6.52	8.03	7.78	5.72	5.72	0.88

Lastly, he best measures of risk have the following properties[298]:

[297]'ibid, pp.42.

- There should be no incentive for a manager to manipulate the measure to his or her advantage.
- The measure should be relatively easy to interpret. The mathematical power of a measure does not matter, if it cannot be calculated and interpreted with relative ease.
- It should apply in a uniform way to managers of all sizes.

4.2.4. INTERNATIONAL INVESTMENTS

This section provides additional information on the requirements, disclosures, and recommendations that are specifically applicable to international investments.

4.2.4.1. PERFORMANCE CALCULATIONS

AIMR recommends the use of trade date rather than settlement-date reporting, because the volatility of different equity and currency markets plus the lengthy settlement periods in some countries make the issue of trade-date versus settlement-date reporting particularly important for international portfolios[299].

Depending on tax status and national treaties, foreign taxes that may be recoverable on financial transactions by a foreign investor present a performance problem unique to international investors. Portfolio returns should be calculated net of withholding taxes on dividends, interest and capital gains. Comparison benchmarks may be shown gross (no withholding taxes taken) or net (after withholding taxes); if net, the amount of taxes withheld should mirror the perspective of the client or prospective client. Assuming that net indexes are easier to outperform than gross indexes, presentations must indicate whether the benchmark is gross or net of taxes; if net, the assumed tax rate must be disclosed. Particularly in emerging markets, if applicable, net performance should be calculated after subtracting potential capital gains taxes on unrealized gains. If this is not done, this maybe because of the collection of the taxes only after funds are taken out of the country, then disclosure of the percentage of the portfolio involved is

---

[298] ibid, pp.43.
[299] ibid, pp.44.

recommended. Further discussion of benchmarks and foreign taxes on financial transactions is included in the last part of this section, namely 'Gross versus Net Dividend Benchmarks'[300].

If possible, conversion of a benchmark and a portfolio into the base currency should be carried out using the same exchange rates. But if this is not possible, any significant deviations should be noted .[301] Managers may choose which exchange rates to utilize to convert performance.

4.2.4.2. CONSTRUCTION OF COMPOSITES

There is no absolute rules that govern when to include or exclude portfolios form a composite. Managers of international portfolios must be the final judges of which portfolios belong in a composite and when restrictions are likely to render a portfolio unrepresentative of a particular style. Some managers make portfolio country-weighting decisions based upon a published index. Here, portfolios running against different indexes belong in separate composites because the country weightings will differ. A manager who has a tendency of not changing portfolio construction based on the benchmark might have only one global composite. Portfolios must not be moved in and out of composites except for acceptable changes in investment objectives or constraints[302].

The following are some examples of the types of rules that managers can use when constructing composites of international portfolios[303]:

- Balanced portfolios with differing asset mixes (e.g., 60 percent equity/40 percent bond versus 40 percent equity/60 percent bond).
- Portfolios with different benchmarks. Investment restrictions can vary greatly from client to client. A practical and objective way to deal with this problem is to specify a level of constraint on the portfolio for composite membership.

---

[300] ibid.
[301] Base currency refers to the currency of the country in which the investor s based; for example, for a U.S. -based investor, the base currency would be U.S. dollars. Local currency refers to the currency of the country of the interest; for example, yen would be the local currency for the Japanese component of a portfolio.
[302] AIMR, 'Performance Presentation Standards', op. cit., pp.45.
[303] ibid.

- Portfolios with various levels of constraints with respect to the same benchmark. Portfolios with a constraint as to how much their portfolio composition can deviate from the benchmark weightings may not belong to the same composite as portfolios that are totally unconstrained.
- Portfolios that invest a large portion of their assets in countries outside the benchmark. These portfolios may be put in a composite separate from portfolios that invest only in countries included in the benchmark. A stated minimum percentage invested in benchmark countries may be beneficial in defining the composite.

Like for the domestic composites, the calculation and exhibition of measures of dispersion for portfolio returns within a composite for each time period is recommended.

4.2.4.3. THE CREATION OF STAND-ALONE COMPOSITES

The creation of stand-alone composites from subsectors or carve-outs of larger international portfolios is only in compliance, if these subsectors were actually managed as independent entities with their own cash allocations and currency management. The results for a subsector or carve-out that was not treated as a separate entity must be supplied as a supplemental information to the composite or composites from which the carve-out was drawn. If the stand-alone composite is a subset or carve-out from a larger composite, the manager must disclose. The subsector's assets as a percentage of the larger composite is also required[304].

The return of a stand-alone composite must be presented with a list of the underlying composites from which the subsector was drawn. Also, the percentage of each composite the subsector represents should also be presented, if a stand-alone composite is designed using subsectors drawn from multiple composites. Performance for each of the larger composites must be made accessible to prospective clients. Although the inclusion in the subsector or carve-out of all qualifying portfolios is preferred, the presentation of subsector results as supplemental information may be based on representative portfolios since this is disclosed[305].

---

[304] ibid, pp. 46.
[305] ibid, pp.47.

4.2.4.4. HEDGED AND UNHEDGED PORTFOLIOS AND RETURNS EXCLUDING THE EFFECT OF CURRENCY

Portfolios that are permitted to use currency hedging should not be included with portfolios that cannot use hedging instruments, when a composite is to be compared to an unhedged benchmark. When expressing the return of a portfolio excluding the effect of currency, the return should be presented fully hedged back to the currency of that portfolio, when expressing the return of a portfolio excluding the effect of currency. This is because the investor cannot actually achieve the local return of a market that is denominated in a currency different from the portfolio's base currency[306].

Despite a more accurate methods is to take the percentage difference between the total in base currency and the total fully hedged into base currency, the total return from currency can be nearly approximated by taking the percentage between the total return in base currency and the total return in local currency[307].

4.2.4.5. BENCHMARK REPORTING: GROSS VERSUS NET OF WITHHOLDING TAXES

The standards recommend calculation of portfolio returns net of withholding taxes on dividends, interest and capital gains. Some comparison benchmarks are published on a 'gross' and on a 'net' basis. While gross means a total return including capital appreciation plus income, net means a gross return with interest or dividend income on a 'net of withholding taxes' basis. Managers must mention whether composite and benchmark returns are net of foreign withholding taxes and must mention the assumed withholding tax rate used to calculate a net benchmark total return. Benchmark on a net basis from the base currency withholding tax perspective will be an easier and more suitable bogey to be measured against. Also, the effects of withholding taxes will vary depending upon the investor's base country[308].

---

[306] AIMR, 'Performance Presentation Standards', op. cit., pp.48.
[307] ibid.
[308] ibid, pp.50.

Ideally, calculation of net indexes should be from the tax perspective of the client, but calculation of net indexes from each perspective could be complex because of data limitations[309]. A widely used methodology for calculating monthly net-of-dividend tax benchmark is as follows:

{(Current Price Index / Previous Price Index)
x [(Current Monthly Yield / 100)
x (1 - Withholding Tax %) + 1] - 1} x 100

The Table below provides an illustration of this calculation[310].

Table - Return to Australian Portfolio in U.S.A. Dollars

Current Price Index	201.466
Previous Price Index	210.936
Annualized Yield	4.2
Monthly Yield	.35
Withholding Tax	30%
Published Returns	
Price	-4.49
Net	-4.25

Calculation:

$$\left\{\left(201.466/210.936\right) \text{ x } \left[(.35/100) \text{ x } (1 - .30) + 1\right] - 1\right\} \text{ x } 100 = -4.25\%$$

The treatment of income in some international indexes is inexact because income is applied monthly as one-twelfth of the annual dividend yield rather than accounting for the dividends as they are received[311].

Some fixed-income portfolio benchmarks are calculated net of withholding taxes. Just like in the equity portfolios, the actual effect of taxes depends on the investor's home country. For example, U.S.A.-based investors are subject to a 10 percent withholding tax in Japan, while Japan-based

[309] ibid.
[310] ibid.
[311] ibid.

nesters are not subject to that tax. So the same net benchmark could not be used for both investors[312].

4.2.5. SEC POSITION ON ADVERTISING PERFORMANCE

Activities of investment advisors, as defined in the Investment Advisors Act of 1940, are subject to the Law and to the rules and regulations of the Securities and Exchange Commission. Whether or not investment advisors are registered with the SEC, their advertising of investment performance is subject to the SEC's scrutiny under Section 206 of the Investment Advisors Act - the general antifraud provisions - and Rule 206(4)- 1. The term 'advertising' is broadly defined as any written communication addressed to more than one person, or a communication in the media, relating, among other things, to securities investment services[313].

The requirements include disclosures in connection with the presentation of both actual and model results. In November 1989, the SEC announced that for periods beginning May 27, 1990, all performance information must reflect deduction of an advisor's actual fees. For periods before that date, model fees that meet certain standards might be used. The SEC indicated that although performance information must be presented net of advisory fees, it is permissible in one-on-one presentations to present performance information without the deduction of advisory fees. The SEC defines one-on-one presentations as manager performance presentations to any client, prospective client, or affiliated group entrusted to consider manager selection and retention. Communications by managers can, therefore, be made to multiple representatives of a given prospect, even if there are several portfolios within the group. Any written performance presentation materials distributed to more than one client or prospect, in other than one-on-one presentations, must present performance results after deduction of management fees[314].

In presenting performance gross of fees, however, a number of additional disclosure requirements must be met. The SEC stated that performance advertising that does not deduct advisory fees may be delivered to a consultant for the prospective client as long as the investment advisor

---

[312] ibid, pp.51.
[313] ibid, pp.61.
[314] ibid.

restricts the consultant's use of the performance information to one-on-one presentation provided that the four disclosures specified below are made[315].

1. disclosure that the performance figures do not reflect the deduction of investment advisory fees;
2. disclosure that the client's return will be reduced by the advisory fees and any other expenses it may incur in the management of its investment advisory account;
3. disclosure that the investment advisory fees are described; and
4. a representative example (e.g., a table, chart, graph, or narrative) which shows the effect an investment advisory fee, compounded over a period of years, could have on the total value of a client's portfolio.

4.2.6. PORTABILITY OF INVESTMENT RESULTS

The AIMR Performance Presentation Standards state that performance results of a past affiliation may not be used to represent the historical record of a new affiliation or a newly formed entity. The guiding principle, according to the standards, is that performance is the responsibility of the firm, not that of the individual portfolio manager[316]. Changes in a firm's organization should not lead to alteration of composite results. Therefore, composites should include all accounts managed by a member of a firm, even if the individual responsible for the past results is no longer with the firm. Composites should not include portfolios managed by the members of the firm before they joined the firm[317].

Performance data from a prior firm can, however, be used as supplemental information with the proper disclosures. The manager must give credit for the performance to the prior affiliation and describe his or her responsibilities at the previous employer. If the responsibilities are accurately portrayed, the market will determine how the record should be interpreted in light of the new affiliation or entity. The historical results of the previous affiliation cannot be linked with the results of the new affiliation or newly formed entity. The non-linking of records is a key factor.

---

[315] AIMR, Performance Reporting for Investment Managers', op. cit., pp. 14.
[316] ibid, pp. 5.
[317] AIMR, 'Performance Presentation Standards', op. cit., pp.63.

In addition to the AIMR standards, a firm must also meet the SEC requirements regarding the use of past performance records[318]. The use of a predecessor's performance could be misleading if one or more individuals other than those at the successor organization played a role in the prior firm's strategy (other investment committee members), security selection (research analysts), or trading (if trading strategies are integral to the firm's overall strategy)[319].

According to the standards, if a newly formed entity constitutes a change in name or ownership only, i.e., all previous decision makers have transferred to the new entity, all client assets have transferred, access to research records remains the same, and the management of the new firm is confident that there will be no misrepresentation in presenting the record of the previous firm as representing the historical record of the new entity, the guideline of 'the record belong to the firm' applies. This means that, in this instance, the record would stay with the firm that has simply undergone a change in name or ownership only[320].

4.2.7. SAMPLE PRESENTATIONS

Presentation 1. XYZ Investment Firm Performance Results January 1, 1984 - December 31, 1993, Growth-Plus-Income Balanced Composite[321]

Year	Total Return	Benchmark Return*	Number of Portfolios	Total Assets End of Period ($Millions)	Percent of Firm Assets
1984	12.1%	9.4%	6	$50	80%
1985	24.2	26.4	10	85	82
1986	17.0	16.4	15	120	78
1987	(3.3)	(1.7)	14	100	80
1988	15.8	12.8	18	124	75
1989	16.0	14.1	26	165	70
1990	2.2	1.8	32	235	68
1991	22.4	24.1	38	344	65
1992	7.1	6.0	45	445	64
1993	8.5	8.0	48	520	62

* Presentation of benchmark returns is not required.

[318] ibid.
[319] ibid.
[320] ibid, pp.64.
[321] ibid, pp.65.

Notes:

1. These results have been prepared and presented in compliance with the AIMR Performance Presentation Standards for the period 1/1/88 through 12/31/93. The full period is not in compliance. Prior to 1/1/88, not all fully discretionary portfolios were represented in appropriate composites. Composite results for the years 1984 through 1987 include the five largest institutional portfolios that were managed in accordance with the growth-plus-income strategy. These five accounts were consistently represented in the composite for the full period from 1984 through 1987.
2. Results for the full historical period are time weighted. From 1984 through 1990, results are calculated yearly, and the composites are asset weighted by beginning-of-year asset values. After January 1, 1991, composites are valued quarterly, and portfolio returns are weighted by using beginning-of-quarter market values plus weighted cash flows.
3. The benchmark: 60% S&P 500; 40% Lehman Intermediate Aggregate. Annualized Compound Composite Return = 11.9%. Annualized Compound Benchmark Return = 11.4%.
4. Standard deviation in annual composite returns equals 8.24% versus a standard deviation in the yearly benchmark returns of 8.53%.
5. The dispersion of annual returns as measured by the range between the highest and lowest performing portfolios in the composite is as follows: 1984, 3.2%; 1985; 5.4%; 1986; 3.8%; 1987; 1.2%; 1988; 4.3%; 1989; 4.5%; 1990; 2.0%; 1991; 5.7%; 1992; 2.8%; 1993; 3.1%.
6. Performance results are presented before management and custodial fees. The management fee schedule is attached.
7. No alteration of composites as presented here as occurred because of changes in personnel or other reasons at any time.
8. Settlement-date accounting is used prior to 1990.
9. A complete list of firm composites and performance results is available upon request.

Presentation 2. XYZ Investment Firm Performance Results 1991 and 1992, Segment Returns for Medium-Risk Balanced Composite[322]

Composite	Total Return	Equity-Only Return	Fixed-Income Only Return	Cash-Only Return
1992 Return	5.2%	5.0%	6.1%	3.3%
Percent of Assets	100	45	45	10
1991 Return	19.5	29.4	15.2	5.5
Percent of Assets	100	44	36	20

[322] ibid, pp.66.

Presentation 3. Sample Verification Statements[323]

Level I: We have examined, according to the Level I requirements for verification, the accompanying Statement of Performance for XYZ Firm for the year ended December 31, 1993. In our opinion, the Statement of Performance presents fairly the composite performance of XYZ Firm for the year ended December 31, 1993, in conformity with the Performance Presentation Standards established by the AIMR as set forth in the accompanying Notes.

Level II: We have examined, according to the Level II requirements for verification, the accompanying Statement of Performance for XYZ Firm for the year ended December 31, 1993. In our opinion, the Statement of Performance presents fairly the investment performance of XYZ Firm for the year ended December 31, 1993, in conformity with the Performance Presentation Standards established by the AIMR as set forth in the accompanying Notes.

Accompanying Notes: The following information is extracted from and supplemented by the AIMR publication *Performance Presentation Standards*, 1993. This publication is the referral source of full discussion and elaboration of the summary points.

Presentation 4. XYZ realty Fund I Historical Performance, 1983-90[324]

Year	Net Assets ($Millions)	Income (Loss)	Appreciation (Depreciation)	Total Gross Return
1983*	$175	7.0%	0.0%	7.0%
1984	194	9.0	4.0	13.3
1985	189	8.9	4.8	14.0
1986	194	8.4	2.8	11.4
1987	199	7.2	1.4	8.7
1988	195	7.4	-1.4	5.9
1989	203	6.5	0.8	7.3
1990	193	5.3	-9.0	-4.0

*Partial year, three quarters.

[323] ibid.
[324] ibid, pp.67.

1. Returns do not include annual investment management fee of 1% of gross asset value.
2. Assets are appraised annually by an independent Member of the Appraisal Institute appraiser.
3. Income is based on accrual accounting and recognized at the commingled fund level.
4. Returns include interest income from short-term cash investments.
5. Returns are based on audited operating results.
6. Returns presented are net of leverage, which averaged 30% of asset value during 1990.
7. All properties of XYZ Realty Fund I have been included in performance presentation.
8. The sum of the income return component and appreciation return component may not equal the total gross return. This is due to the time-weighting of component quarterly returns.

5. THE CODE OF ETHICS AND THE STANDARDS OF PROFESSIONAL CONDUCT

A financial analyst should conduct himself with integrity and dignity and act in an ethical manner in his dealings with the public, clients, customers, employers, employees, and fellow analysts. A financial analyst should conduct himself and should encourage others to practice financial analysis in a professional and ethical manner that will reflect credit on himself and his profession. A financial analyst should act with competence and should strive to maintain and improve his competence and that of others in the profession. A financial analyst should also use proper care and exercise independent professional judgment[325].

5.1. PROVISIONS OF CAPITAL MARKET LAW ABOUT INVESTMENT ADVISORS

According to the Capital Market Law in Turkey, the firms that perform advisory activities and authorized by the Law to perform this activity[326]:

- should not make recommendations which are not true, or false, or misleading or exaggerated to their clients.
- should base their recommendations on reliable documents, supportive reports and analysis.
- should ensure that the most appropriate investment decisions to be taken by the clients with respect to their client's monetary position, available investment instruments, liquidity, and risk and return preferences of their clients.
- cannot guarantee a predetermined return to their clients with his/her advises.

---

[325] AIMR, 'Standards Of Practice Handbook', op. cit., pp.2.
[326] 'Sermaye Piyasası Kanunu', Seri V, Tebliğ No: 23, Madde: 9.

- should give priority to their client's interest if and when the interests of the advisor and client conflicts.
- they cannot use the research results for their own or for the another third party's interest, before they present this information to the client.

In the contract between the investor advisor and the client[327]:

- the type and the extend of the service,
- the principles of investment advises and the quality and the presentations of the basic reasons about these advises,
- fees and other commissions that will be collected,
- the duration of the contract,
- the provisions of the law about investment advisor's activities,
- the information about the investment advisor, who is appointed by the firm as the advisor of that client,
- the information about both the authorized firm and the client

should be included.

The investment advisors should also be independent and neutral. They should be educated and experienced enough in order to perform their job properly.

5.2. PROVISIONS OF CAPITAL MARKET LAW ABOUT PORTFOLIO MANAGEMENT

According to the Capital Market Law in Turkey, the firms that perform portfolio management and authorized by the Law to perform this activity [328]:

- should disclose it to their clients, if they get any commission, discount or any other benefits from issuers or intermediaries as a result of a transaction,

---

[327]'Sermaye Piyasası Kanunu', Seri V, Tebliğ No: 23, Madde: 10.
[328]'Sermaye Piyasası Kanunu', Seri V, Tebliğ No: 29, Madde: 12.

- without written consent of the client, cannot buy any capital market instruments more than the market value of the client's portfolio or sell any capital market instruments from the portfolio less than the market value of the portfolio,
- cannot perform any transaction for their own benefit,
- cannot perform any transaction which favors some of the clients with respect to the others, if they manage more than one portfolio,
- should base their investment decisions about portfolios they manage on documents and reasons and should consider the monetary position of their client and should also comply with the agreement,
- cannot guarantee a predetermined return to their clients with their advises.
- should give priority to their client's interest if and when the interests of the advisor and client conflicts.
- should determine the risk/return preferences of the client, record these findings on a written form, keep these documents with the contract and should form the portfolios according to all of these information,
- should not allow the persons employed in the firm to perform transactions by using the opportunities of the firm for their own interest.

5.3. STANDARDS OF PROFESSIONAL CONDUCT

I. Obligation to Inform Employer of Code and Standards[329]

The financial analyst shall inform his employer, that the analyst is obligated to comply with the Code of Ethics and Standards of Professional Conduct. If the employer does not have a copy, he shall deliver a copy of the Code and Standards to his employer[330].

II. Compliance with Governing Laws and Regulations and the Code and Standards

A. Required Knowledge and Compliance[331]

The financial analyst shall maintain knowledge of and shall comply with all applicable laws, rules, and regulations of any government, governmental agency, and regulatory organization

---

[329] AIMR, 'Standards Of Practice Handbook', op. cit., pp.10.
[330] ibid, pp.3.
[331] ibid, pp.17.

governing his professional, financial, or business activities, as well as with these Standards of Professional Conduct and the accompanying Code of Ethics[332].

B. Prohibition Against Assisting Legal and Ethical Violations[333]

The financial analyst shall not knowingly participate in, or assist, any acts in violation of any applicable law, rule, or regulation of any government, governmental agency, or regulatory organization governing his professional, financial, or business activities, nor any act which would violate any provision of these Standards of Professional Conduct or the accompanying Code of Ethics.

C. Prohibition Against Use of Material Nonpublic Information[334]

The financial analyst shall comply with all laws and regulations relating to the use and communication of material nonpublic information. The financial analyst's duty is generally defined as not to trade while in possession of, nor communicate, material nonpublic information in breach of a duty, or if the information is misappropriated.

Duties under the standard include the following: (1) If the analyst acquires such information as a result of a special or confidential relationship with the issuer or others, he shall not communicate the information, or take investment action on the basis of such information, if it violates that relationship. (2) If the analyst is not in a special or confidential relationship with the issuer or others, he shall not communicate or act on material nonpublic information if he knows that such information (a) was disclosed to him, or would result, in a breach of a duty, or (b) was misappropriated. If such a breach of duty exists, the analyst shall make reasonable efforts to achieve public dissemination of such information.

D. Responsibilities of Supervisors[335]

A financial analyst with supervisory responsibility shall exercise reasonable supervision over those subordinate employees subject to his control, to prevent any violation by such persons of applicable statutes, regulations, or provisions of the Code of Ethics or Standards of Professional

---

[332] ibid.
[333] ibid, pp.25
[334] ibid, pp.31
[335] ibid, pp.55.

Conduct. In so doing the analyst is entitled to rely upon reasonable procedures established by his employer[336].

III. Research Reports, Investment Recommendations and Actions

A. Reasonable Basis and Representations[337]

1. The financial analyst shall exercise diligence and thoroughness in making an investment recommendation to others or in taking an investment action for others.
2. The financial analyst shall have a reasonable and adequate basis for such recommendations and actions, supported by appropriate research and investigation.
3. The financial analyst shall make reasonable and diligent efforts to avoid any material misrepresentation in any research report or investment recommendation.
4. The financial analyst shall maintain appropriate records to support the reasonableness of such recommendations and actions.

B. Research Reports[338]

1. The financial analyst shall use reasonable judgment as to the inclusion of relevant factors in research reports.
2. The financial analyst shall distinguish between facts and opinions in research reports.
3. The financial analyst shall indicate the basic characteristics of the investment involved when preparing a research report that is not directly related to a specific portfolio or client.

C. Portfolio Investment Recommendations and Actions[339]

1. The financial analyst shall, when making an investment recommendation or taking an investment action for a specific portfolio or client, consider its appropriateness and suitability for such portfolio or client. In considering such matters, the financial analyst shall take into account (a) the needs and circumstances of the client,(b) the basic characteristics of the investment involved, and (c) the basic characteristics of the total portfolio. The financial analyst shall use reasonable judgment to determine the applicable relevant factors.

---

[336] ibid.
[337] ibid, pp.66.
[338] ibid, pp.74.
[339] ibid, pp.83.

2. The financial analyst shall distinguish between facts and opinions in the presentation of investment recommendations.
3. The financial analyst shall disclose to clients and prospective clients the basic format and general principles of the investment processes by which securities are selected and portfolios are constructed. He shall disclose to the clients any changes that might significantly affect those processes.

D. Prohibition Against Plagiarism[340]

The financial analyst shall not, when presenting material to his employer, associates, customers, clients, or the general public, copy or use in substantially the same form, material prepared by other persons without acknowledging its use and identifying the name of the author or publisher of such material. The analyst may, however, use without acknowledgment factual information published by recognized financial and statistical reporting services or similar sources.

E. Prohibition Against Misrepresentation of Services[341]

The financial analyst shall not make any statements, orally or in writing, which misrepresent (1) the services that the analyst or his firm is capable of performing for the client, (2) the qualifications of such analyst or his firm, and/or (3) the expected performance of any investment.

The financial analyst shall not make any guarantees of any investment or its return except for the communication of accurate information as to the terms of the investment instrument and the issuer's obligations under the instrument[342].

F. Performance Presentation Standards[343]

1. The financial analyst shall not make any statements, orally or in writing, which misrepresent the investment performance that the analyst or his firm has accomplished or can reasonably be expected to achieve.

---

[340] ibid, pp.94.
[341] ibid, pp.100
[342] ibid.
[343] ibid, pp.106.

2. If an analyst communicates individual or firm performance information to a client or prospective client, the analyst shall make every reasonable effort to ensure that such Performance Information is a fair, accurate, and complete presentation of such performance.
3. The financial analyst shall inform his employer about the existence and content of the Performance Presentation Standards (see Part 4. Performance Presentation Standards), and this Standard, and shall encourage his employer to adopt and use the Performance Presentation Standards.
4. If Performance Information complies with the Performance Presentation Standards, the analyst shall be presumed to be in compliance with the III F 2 above.
5. An analyst presenting Performance Information may use the following legend on the Performance Information presentation, but only if the analyst has made every reasonable effort to ensure that such presentation is in compliance with the Performance Presentation Standards:

"This report has been prepared and presented in compliance with the Performance Presentation Standards."[344]

G. Fair Dealing with Customers and Clients[345]

The financial analyst shall act in a manner consistent with his obligation to deal fairly with all customers and clients when (1) disseminating investment recommendations, (2) disseminating material changes in prior investment advice, and (3) taking investment action.

IV. Priority of Transactions[346]

The financial analyst shall conduct himself in such a manner that transactions for his customers, clients, and employer have priority over transactions in securities or other investments of which he is the beneficial owner, and does not operate adversely to their interests. If an analyst decides to make a recommendation about the purchase or sale of a security or other investment, he shall give his customers, clients, and employer adequate opportunity to act on this recommendation before acting on his own behalf.

---

[344] ibid, pp.106.
[345] ibid, pp.121.
[346] ibid, pp.130.

For purposes of these Standards of Professional Conduct, a financial analyst is a "beneficial owner" if he directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, has or shares a direct or indirect pecuniary interest in the securities or the investment.

V. Disclosure of Conflicts[347]

The financial analyst, when making investment recommendations, or taking investment actions, shall disclose to his customers and clients any material conflict of interest relating to him and any material beneficial ownership of the securities or other investments involved that could reasonably be expected to impair his ability to render unbiased and objective advice.

The financial analyst shall disclose to his employer all matters that could reasonably be expected to interfere with his duty to the employer, or with his ability to render unbiased and objective advice.

The financial analyst shall also comply with all requirements as to disclosure of conflicts of interest imposed by law and by rules and regulations of organizations governing his activities and shall comply with any prohibitions on his activities if a conflict of interest exists.

VI. Compensation

A. Disclosure-e of Additional Compensation Arrangements [348]

The financial analyst shall inform his customers, clients, and employer of compensation or other benefit arrangements in connection with his services to them which are in addition to compensation from them for such services[349].

B. Disclosure *of Referral Fees*[350]

The financial analyst shall make appropriate disclosure to a prospective client of any consideration paid or other benefit delivered to others for recommending his services to that prospective client or customer[351].

---

[347] ibid.
[348] ibid, pp.137.
[349]ibid.
[350] ibid, pp.142.

C. Duty to Employer[352]

The financial analyst shall not undertake independent practice which could result in compensation or other benefit in competition with his employer unless he has received written consent from both his employer and the person for whom he undertakes independent employment.

VII. Relationships with Others

A. Preservation of Confidentiality[353]

Unless the financial analyst receives information concerning illegal activities on the part of the client, a financial analyst shall preserve the confidentiality of information communicated by the client concerning matters within the scope of the confidential relationship.

B. Maintenance of Independence and Objectivity[354]

The financial analyst, in relationships and contacts with an issuer of securities shall use particular care and good judgment to achieve and maintain independence and objectivity.

C. Fiduciary Duties[355]

The financial analyst, in relationships with clients, shall use particular care in determining applicable fiduciary duty and shall comply with such duty as to those persons and interests to whom it is owed.

VIII. Use of Professional Designation[356]

The qualified financial analyst may use, as applicable, the professional designation "Member of the Association for Investment Management and Research," "Member of the Financial Analysts Federation," and "Member of the Institute of Chartered Financial Analysts," but only in a dignified and judicious manner. The use of the designations may be accompanied by an accurate explanation (1) of the requirements that have been met to obtain the designation, and (2) of the

---

[351] ibid, pp.142.
[352] ibid, pp. 146.
[353] ibid, pp.152.
[354] ibid, pp.156.
[355] ibid, pp.161.
[356] ibid, pp.170.

Association for Investment Management and Research, the Financial Analysts Federation, and the Institute of Chartered Financial Analysts, as applicable.

The Chartered Financial Analyst may use the professional designation "Chartered Financial Analyst," or the abbreviation "CFA," but only in a dignified and judicious manner. The use of the designation may be accompanied by an accurate explanation (1) of the requirements that have been met to obtain the designation, and (2) of the Association for Investment Management and Research and the Institute of Chartered Financial Analysts.

IX. Professional Misconduct[357]

The financial analyst shall not (1) commit a criminal act that upon conviction materially reflects adversely on his honesty, trustworthiness, or fitness as a financial analyst in other respects, or (2) engage in conduct involving dishonesty, fraud, deceit, or misrepresentation.

5.3.1. COMPLIANCE WITH GOVERNING LAWS AND REGULATIONS AND THE CODE AND STANDARDS : REQUIRED KNOWLEDGE AND COMPLIANCE

The financial analyst shall maintain knowledge of and shall comply with all applicable laws, rules, and regulations of any government, governmental agency, and regulatory organization governing his professional, financial, or business activities, as well as with these Standards of Professional Conduct and the accompanying Code of Ethics[358].

The purpose of the standard is to state the responsibility of AIMR members and nonmember holders of, and candidates for, the CFA designation to comply with the laws and rules of governments, governmental agencies, and self-regulatory organizations, as they carry out their professional, financial, or business activities. AIMR believes that, as a matter of professional responsibility and minimum professional conduct, each investment professional should be aware of, and comply with, laws and rules governing their conduct[359].

---

[357] ibid, pp. 175.
[358] ibid, pp. 17.
[359] ibid.

The Standards of Professional Conduct cover many important areas. However, because financial analysts engage in a wide variety of professional, financial, and/or business activities, the standards cannot provide a guide to proper conduct in every circumstance they may encounter. Therefore, Standard II A sets forth minimum standards of conduct in areas not covered by other standards and requires compliance with laws, rules, and regulations governing conduct. If a financial analyst violates a law, rule, or regulation governing his professional, financial, or business activities, he will come into conflict with this standard. A financial analyst should learn about laws and rules that govern his conduct[360].

When members are working abroad and/or are advising investors about foreign securities, the requirement to be informed of the laws and rules governing their conduct may include the need to be familiar with the securities laws and regulations of governments and self-regulatory bodies in overseas countries.

Members can acquire and maintain knowledge about applicable laws, rules, and regulations via the following actions[361]:

- ***Maintain current files.*** Maintaining, or encouraging their employers to maintain current reference copies of applicable statutes, rules, regulations, and important cases that are readily available to individual members. The employer might be encouraged to distribute such information to members for this purpose.

- ***Keep informed.*** Establishing a procedure under which members are regularly informed about changes in applicable laws, rules, regulations, and case law.

- ***Review procedures.*** Regularly reviewing written compliance procedures to ensure that they reflect current law and provide adequate guidance to employees concerning what is the permissible conduct under the Law.

---

[360] ibid.
[361] ibid, pp.22.

5.3.2. COMPLIANCE WITH GOVERNING LAWS AND REGULATIONS AND THE CODE AND STANDARDS : RESPONSIBILITIES OF SUPERVISORS

A financial analyst with supervisory responsibility shall exercise reasonable supervision over those subordinate employees subject to his control, to prevent any violation by such persons of applicable statutes, regulations, or provisions of the Code of Ethics or Standards of Professional Conduct. In doing so the analyst is entitled to rely upon reasonable procedures established by his employer[362].

The purpose of the standard is to state the responsibility of AIMR members and nonmember holders of ,and candidates for, the CFA designation to prevent violations of law and violations of the Code and Standards by persons acting under their supervision[363].

Any investment professional who has subordinate employees subject to his control exercises supervisory responsibility. The conduct that constitutes reasonable supervision depends on the number of employees supervised by the analyst or manager and the work performed by those supervised employees. Some investment analysts and managers, who supervise large numbers of subordinates, must delegate most supervisory duties. Their responsibility includes instructing those to whom supervision is delegated about methods to prevent and detect violations[364].

Supervisory responsibility exists whether or not the underlying conduct is covered by the Code and Standards, if it is otherwise covered by governmental laws or regulations or rules of self-regulatory organizations[365]. Under this standard, members who have supervisory responsibility must exercise it with all employees.

---

[362] ibid, pp.55.
[363] ibid.
[364] ibid, pp.56.
[365]National Association of Securities Dealers, Rules of Fair Practice, Article III, §27, Supervision, and Article III, §35, Communications with the Public; New York Stock Exchange, Rule 344, Supervisory Analysts, and Rule 472, Communications with the Public. In June 1988 the SEC approved proposed ammandements to Rules 342, Offices - Approval, Supervision and Control, 352, Reporting Requirements, and 476, Disciplinary Proceedings Involving Charges Against Members, Member Organizations, Allied Members, Approved Persons, or Employees, to supplement existing internal compliance procedures by imposing additional trade review,inquiry, and reporting requirements.

The analyst or investment supervisor is not expected to have extensive legal knowledge, but is expected to know basic legal requirements in his area and to know when to submit questionable issues to legal advisers or other compliance personnel[366]. The member-supervisor is expected to have in-depth knowledge of the Code and Standards and to apply this knowledge in discharging his responsibilities.

The supervisor is also expected to understand what constitutes an adequate compliance system for his firm and to make reasonable efforts to see that appropriate procedures are adequately established, documented, and communicated to covered personnel. The supervisor must make every effort to detect fraudulent or deliberately misleading statements or practices as well as other improper or inadequate work or conduct. However, a supervisor should bring an inadequate compliance system to the attention of management and recommend corrective action. If it is clear that the analyst or investment manager cannot discharge supervisory responsibilities because of the absence of a compliance system, or because of an inadequate compliance system, the supervisor should not continue to accept supervisory responsibility until reasonable procedures permitting him to exercise reasonable supervision are adopted. (See Standards II A and II C in Part 5.3.)

A supervisor complies with this Standard by identifying situations in which legal violations or violations of the Code and Standards are likely to occur, by establishing compliance procedures, and by reviewing the actions of employees to prevent such violations and to enforce the procedures. The following compliance procedures are illustrative and are designed to point out problem areas and help supervisors prevent violations. Exhibit A concerns with the research reports and detailed matters to be satisfied with regard to appropriate procedures. Exhibit B concerns with the portfolio management[367].

---

[366]For an example of sanctions imposed on a supervisor for failure to recognize a questionable issue regarding compliance with NASD standards, see In reWall Street West, Inc., SEC Rel. No. 34-18320, (1981-2), Fed. Sec. L. Rep. (CCH) ¶83,069 (December 9,1981).

[367] AIMR, 'Standards Of Practice Handbook', op. cit., pp.59.

5.3.2.1. EXHIBIT A : RESEARCH REPORTS

General Considerations[368]

1. Provisions of all relevant securities acts and regulations are met.
2. Rules of self-regulatory organizations such as stock exchanges, the National Association of Securities Dealers, and the Investment Dealer's Association are followed.
3. Compliance with the AIMR Code and Standards is achieved.
4. All appropriate sources of information are used.
5. Conclusions are based on reasonable and adequate research.
6. Facts are clearly distinguished from opinions.
7. Any part of the report appearing to indicate a definite assurance of gain is deleted; the tone of the report is not too promotional and avoids exaggeration, unwarranted superlatives, and flamboyant or promissory language.

Administrative Process[369]

1. Report is dated and all significant information is reasonably current.
2. Current price, indicated dividend yield, and price-earnings ratio of all recommended securities are given.
3. All opinions, projections, predictions. and estimates are labeled as such, not as facts.
4. Supporting data for recommendations is provided with the legend "Additional Information Available Upon Request" or "Report on Basic Characteristics Available Upon Request" prominently indicated.
5. The supervisor checks calculations on a test basis.
6. The report discusses appropriate relevant factors and the basic characteristics of the investment.
7. The analyst completes any applicable stock exchange or other related checklists.
8. The firm's ownership of the stock or related securities is disclosed.
9. Any relevant firm underwritings within the last three years are disclosed in which the dealer was manager or co-manager. The firm's market-making activities are disclosed.
10. The security is checked to verify that it is not on a restricted list or in registration.

---

[368] ibid, pp.60.
[369] ibid.

11. Provisions are made for simultaneous dissemination of all initial copies of the report.

Ethical and Professional/ Considerations[370]

1. An adequate investigation is made.
2. Reasonable steps are taken to evaluate the accuracy of the data when the analyst's judgment is based on historical information received from third-party sources.
3. The analyst is properly prepared for corporate interviews.
4. If the analyst or any associated analyst is on loan to the firm's underwriting department at any point, this fact is disclosed and special care is taken regarding nonpublic information.
5. The personal securities transaction reports to the firm are checked for the analyst or supervising analyst and his immediate family.
6. The analyst has no special relationship with the issuer.
7. The supervisor's firm has no partners or directors who are also directors of the recommended company.
8. The analyst or supervising analyst receives no material gratuities or hospitality from the recommended companies that may affect his objectivity. If gratuities are received, they are specified.
9. The analyst or supervising analyst should not accept from financial intermediaries such as brokers or dealers through whom the firm may either trade securities and derivatives or receive services of value related to the investment process any material gratuities or hospitality that may affect his objectivity.
10. If the report is not prepared under the firm's direct supervision, outside authors are identified and given credit.
11. Special commissions, research, soft dollar arrangements, performance or incentive fees, and commitments are reviewed to determine whether any of these require steps to be taken for legal compliance. Disclosure requirements and appropriate disclosures are made.

---

[370] ibid, pp.61.

5.3.2.2. EXHIBIT B : PORTFOLIO MANAGEMENT

Over-all Responsibility[371]

1. The portfolio manager is not influenced in his decision or decisions by excessive entertainment or other incentives.
2. The portfolio manager is objective in his judgment in buying or selling a security or group of securities.
3. The portfolio manager gives priority to portfolio trading over his own trading.
4. The portfolio manager conforms with the investment objectives and policy guidelines established by the client and/or the employer.

Supervisory Activities[372]

1. The portfolio manager provides the supervisor (that is, the firm) with a list of trading (with dates) of securities and commodities for his account and that of his immediate family.
2. Portfolio decisions are not influenced by excessive entertainment or other incentives. The portfolio manager at all times gives priority to portfolio trading over his own.
3. The portfolio manager receives no other compensation or income that might conflict with his duties.
4. No material nonpublic information is received or used.
5. The portfolio manager personally or through his business expenditures (e.g., through the brokerage) has paid out no amounts that might directly influence the receipt of other business by the firm.
6. Special commissions, research, other soft dollar arrangements, performance fees, and commitments are examined to determine whether any of these require steps to be taken for legal compliance. Disclosure requirements and appropriate disclosures are made.
7. Adequate managerial controls are provided over the supervising function to protect both the supervisor and the portfolio managers.
8. Care is taken to determine the portfolio manager's fiduciary duty to his clients. The employer has written guidelines or a policy for voting proxies and the portfolio manager follows it if he is accountable for voting proxies. A record of the vote is maintained.

---

[371] ibid, pp.62.
[372] ibid.

9. Investment decisions are consistent with the employer's investment process and with the clients' investment policies and objectives.

5.3.3. RESEARCH REPORTS INVESTMENT RECOMMENDATIONS AND ACTIONS: PROHIBITION AGAINST MISREPRESENTATION OF SERVICES

The financial analyst shall not make any statements, orally or in writing, which misrepresent (1) the services that the analyst or his firm is capable of performing for the client, (2) the qualifications of such analyst or his firm, or (3) the expected performance of any investment. Also the financial analyst shall not make any guarantees of any investment or its return except communication of accurate information as to the terms of the investment instrument and the issuer's obligations under the instrument[373].

The purpose of this standard is to state the responsibility of AIMR members and nonmember holders of, and candidates for, the CFA designation to avoid misrepresentation with regard to either the services, qualifications, or the expected performance of any investment, and to prohibit inappropriate assurances about any investment or its return. If a misrepresentation appears in a research report or as part of an investment recommendation, it will also violate Standard III A 3[374].

Misrepresentation can be defined as the act of representing something improperly or imperfectly or giving a false impression. Although the standard is intended to apply to misrepresentation that is material, it does not condone inconsequential or inadvertent misrepresentation. A material misrepresentation includes any untrue statement of a material fact or any statement that is otherwise materially false or misleading. Willful misrepresentation is probably easier to spot than instances of unintended carelessness by financial analysts or firms, but penalties are involved in either case[375].

---

[373] ibid, pp.100.
[374]Morrill - Stanfill & Co., (1978) Fed. Sec. L. Rep. (CCH) ¶81, 682 (April 13, 1978).
[375]In re Melhorn, SEC Administrative Proceeding File No. 3-7165 (March 31, 1989); see also In re Investors Portfolio Management, Inc., SEC Administrative Proceeding File No. 3-6729 (June 26, 1990).

Care should be taken to ensure that misrepresentation does not occur in either oral representations, advertising, whether in the press or through brochures, or in written materials, whether publicly disseminated or not[376].

The standard prohibits statements or assumptions that an investment is "guaranteed[377]," or superior returns can be expected based on the assumption that an analyst's past success shall or may be repeated in the future.

The standard also prohibits inferences that an analyst's membership affiliation with the AIMR or his achievement of any levels of the CFA examination process, including award of the CFA designation itself, empower the analyst with (a) the ability to produce superior investment results or (b) any special or unique knowledge or expertise with regard to financial and investment matters[378].

Unintentional misrepresentations concerning the services an analyst or investment manager or firm is capable of performing, or the qualifications of an analyst or his firm, can be prevented if each employee of a firm and each analyst/manager understands the limits of the firm's or the individual's capabilities and the need to be accurate and complete in presentations[379].

Firms can provide guidance for employees who make written or oral presentations to clients or potential clients by providing a written list of the firm's available services and a description of the firm's qualifications. Registered investment advisers in the United States are required to deliver a written description of these matters under the brochure rule of the Investment Advisers Act (Rule

---

[376]In re Investors Portfolio Management, Inc., SEC Administrative Proceeding File No. 3-6729 (June 26, 1990) (advertisement failed to disclose that high yield product was based on an unusually risky investment strategy); In re Security Evaluation, Inc., (1971-2) Fed. Sec. L. Rep. (CCH) ¶78, 786 (May 8, 1972) (failure to describe limitations of 'device' whereby firm performed statistical analysis of clients' portfolios); In re Spear, SEC Rel. No. IA-188, (1964-66) Fed. Sec. L. Rep. (CCH) ¶77, 216 (March 25, 1965) (advertisement claiming ability to forecast securities prices failed to disclose the inherent difficulty thereof). For further elucidation on the constraints on advertising, see In re Bridwell & Co., , SEC Rel. No. IA-180, (1964-66) Fed. Sec. L. Rep. (CCH) ¶77, 183 (December 18, 1964); SEC Private Letter Ruling, A.R. Schmeidler & Co., Inc.

[377]In re Grillo, SEC Administrative Proceeding File No. 3-7292 (December 21, 1989).

[378]AIMR, 'Standards Of Practice Handbook', op. cit., pp.101.

[379] ibid.

204-3). In certain instances, a report of disciplinary actions taken against the firm or an employee and any precarious financial condition must be provided to clients and prospective clients[380].

5.3.4. RESEARCH REPORTS, INVESTMENT RECOMMENDATIONS AND ACTIONS: PERFORMANCE PRESENTATION STANDARDS

1. The financial analyst shall not make any statements, which misrepresent the investment performance that the analyst or his firm has accomplished or can reasonably be expected to achieve.

2. If an analyst communicates individual or firm performance information to a client or prospective client, the analyst shall make every reasonable effort to ensure that such Performance Information is a fair, accurate and complete presentation of such performance.

3. 'The financial analyst shall inform his employer about the existence and content of the Association for Investment Management and Research's Performance Presentation Standards and this Standard III F, and shall encourage his employer to adopt and use the Performance Presentation Standards.

4. If Performance Information complies with the Performance Presentation Standards, the analyst shall be presumed to be in compliance with III F 2 above.

5. An analyst presenting Performance Information may use the following legend on the Performance Information presentation, but only if the analyst has made every reasonable effort to ensure that such presentation is in compliance with the Presentation Standards:

'This report has been prepared and presented in compliance with the Performance Presentation Standards."

---

[380]Securities and Exchange Commission, Financial and Disciplinary Information that Invetsment Advisers must Disclose to Clients, Release No. IA-1083 (September 25, 1987).

The purpose of this standard is to state the responsibility of AIMR members and nonmember holders of, and candidates for, the CFA designation to avoid misrepresentation with regard to investment performance of the member or his firm. The overall philosophy underlying this standard is the need for full disclosure of investment performance data to clients and client prospects. Certain statistics and presentation data have been delineated as basic requirements. Nevertheless, the standard is a performance *presentation* standard, not performance *measurement* standard. Therefore, the central theme is that investment managers may present any reasonable statistics provided that their derivation, and particularly any exclusions therefrom, are highlighted and made abundantly clear[381].

An analyst must give a fair and complete presentation of performance information whenever communicating data with respect to the performance history of individual accounts, composites of groups of accounts, or composites of the analyst's or the firm's results. Accordingly, misrepresentations of past performance or reasonably expected performance are prohibited[382].

Misrepresentations about the investment performance of the firm can be avoided if the analyst maintains data about the firm's investment performance in written form and understands the classes of investments or accounts to which that data applies and the risks and limitations inherent in using such data. In analyzing information about the firm's investment performance, the analyst should ask:

l. How many years' past performance does this information reflect? Does it reflect performance for the prior year only, after several years of poor performance? ' An average of several years' performance? Has the performance been measured in accordance with AIMR standards?

2. Does investment performance vary widely among different classes' of funds or accounts? If so, the analyst must consider describing investment performance by classes and not by an overall average figure, accurately explaining what the performance figures represent.

---

[381] AIMR, 'Standards Of Practice Handbook', op. cit., pp.106.
[382] ibid, pp.107.

Analysts should refer to the Report of the Performance Presentation Standards Implementation Committee published by AIMR. This comprehensive report contains the performance presentation standards, implementation guidelines, extensive explanations of their application, a summary of applicable legal standards, performance calculations, a checklist, and sample performance tables, among other materials[383].

5.3.5. COMPENSATION : DISCLOSURE OF ADDITIONAL COMPENSATION ARRANGEMENTS

The financial analyst shall inform his customers, clients, and employer of compensation or other benefit arrangements in connection with his services to them which are in addition to compensation from them for such services[384].

The purpose of the standard is to state the responsibility of AIMR members and nonmember holders of, and candidates for, the CFA designation to provide complete disclosure of the sources and nature of their compensation or other benefits received for services rendered, including compensation by the client or customer directly, and any incremental compensation or other benefit received by separate agreement or indirectly from third parties. The client, customer, or employer is entitled to have full knowledge of compensation or other benefit arrangements to assess the true cost of the service properly. In addition, because compensation or other benefit arrangements may have a material impact on loyalties and objectivity, the information is necessary to evaluate the actions and motivations of the analyst or investment manager[385].

The standard requires that each investment professional inform his customers, clients, and employer about additional compensation or other benefit agreements[386]. Information concerning a financial analyst's compensation should be provided to the financial analyst's customers, clients,

---

[383] ibid.
[384] ibid, pp.137.
[385] ibid.
[386]For cases discussing the duty of disclosure for investment professionals generally, see U.S. v. Hibler (C. D. Cal.), SEC Rel. No. LR-9490 (November 2, 1981); In re Cortes, SEC Rel. No. IA-743 (January 7, 1981); In re Pitts, SEC Rel. No. 34-17274 (November 6, 1980); In re Gatliff and Martinson, SEC Rel. No. 34-16680 (March 20, 1980); SEC v. Miller Advisory Services, SEC Rel. No. LR--IA-705 (November 5, 1979).

and employer in writing. The financial analyst also should make an immediate written report to his employer specifying any compensation he proposes to receive for services rendered for the employer or the employer's customers or clients. This written report should state the terms of any oral or written agreement under which the financial analyst will receive additional compensation. No arrangement should be entered into without the employer's approval[387].

The financial analyst also should disclose in writing any compensation he receives from an issuer or other person other than his employer. This written statement should describe the compensation, such as fees for referring brokerage or for recommending an issuer's securities; identify the person or firm paying the compensation; and describe the conditions under which the compensation will be earned. If an employer or a financial analyst manages a portfolio for which the fee is based on a share of capital gains or capital appreciation, this should be disclosed to other customers or clients[388].

The investment professional also should disclose, with the approval of his employer, special compensation arrangements with the employer that might conflict with client or customer interests. Information on the analytical compensation packages could be included in the company service promotional literature[389].

5.3.6. COMPENSATION : DISCLOSURE OF REFERRAL FEES

The financial analyst shall make appropriate disclosure to a prospective client or customer of any consideration paid or other benefit delivered to others for recommending his services to that prospective client or customer[390].

---

[387] AIMR, 'Standards Of Practice Handbook', op. cit., pp.137.
[388] Securities and Exchange Commission, Exemption to Allow Registered Investment Advisers to Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account, Rel. No. 1A 996 (November 14, 1985).
[389] AIMR, 'Standards Of Practice Handbook', op. cit., pp.140.
[390] ibid, pp.142.

The purpose of the standard is to state the responsibility of AIMR members and nonmember holders of, and candidates for, the CFA designation to inform customers and clients of fees paid or other benefit received for referrals of customers and clients[391].

Appropriate disclosure means advising the customer or client before entering into any formal agreement for services "of any consideration paid or other benefit delivered to others for recommending his services"[392]. In addition, the nature of the consideration or benefit should be disclosed. Consideration includes all fees, whether paid in cash, soft dollars, or in kind.

The following checklist includes actions that must be followed by the financial analysts[393]:

- Disclose all agreements. Disclose the existence and terms of any referral fee agreement to any prospective customer or client as soon as the analyst learns that the prospective customer or client has been referred pursuant to such an agreement.

- Describe the nature of the consideration and the estimated dollar value of the consideration.

- Put it in writing. Give a prospective customer or client a written disclosure statement no later than the time the person enters into a formal agreement for services.

- Consult a supervisor and legal counsel about any prospective arrangement regarding referral fees.

- Follow the instructions of legal counsel in complying with Investment Advisers Act Rule, if the financial analyst works for an investment adviser.

---

[391] ibid.
[392] Rolf v. Blyth, Eastmean Dillon & Co., Inc., 424 F. Supp. 1021 (S.D.N.Y. 1977), aff d 570 F.2d 38 (2d Cir. 1978), cert. den. 439 U.S. 1039, 99 S. Ct. 642 (December 4, 1978); In re Stein Roe & Farnham, Inc., SEC Administrative Proceeding File No. 307303 (January 22, 1990).
[393] AIMR, 'Standards Of Practice Handbook',op. cit., pp.144.

5.4. INTERNATIONAL APPLICATION OF THE CODE AND STANDARDS

AIMR's goal is to ensure that membership in the organization is recognized as representing compliance with the highest ethical and professional standards and to encourage the development of homogeneous international standards[394].

An International Regional Committee, reporting to the Professional Conduct Committee, has responsibility for the administration of the member disciplinary process relating to the Code of Ethics and Standards of Professional Conduct outside the United States and Canada[395].

Standard II A requires members to comply with applicable governing laws and regulations and the Code and Standards. In accordance with this standard, members in all countries should comply with the Code and Standards as well as with the laws and regulations of the countries in which they are domiciled. Members pursuing their profession outside their domestic markets should also comply with the local laws and regulations[396].

Standard III A requires a financial analyst to have a reasonable basis for his recommendations and to avoid any material misrepresentations. Standard III B 1, Standard III B 2, and Standard III B 3 require the use of reasonable judgment and the communication of the basic characteristics of investments in research reports. Standard III C requires that a financial analyst to consider the appropriateness and suitability of an investment for a particular portfolio or client. In accordance with these requirements, members should take into account the differences in various countries' accounting standards, disclosure requirements, the extent of compliance, local market liquidity, capital and currency controls, and other relevant factors in trading securities in foreign markets and in advising their clients with respect to foreign securities[397].

When there is an absence of a specific local or other regulatory requirements, the Code and Standards should govern members' actions. When the Code and Standards impose a higher degree of responsibility or higher duty than local or other law or custom, the member should comply

---

[394] ibid, pp. 180.
[395] ibid.
[396] ibid, pp. 181.
[397] ibid.

with the Code and Standards. Members must also comply with the laws and regulations of their home country while residing and working in foreign countries or trading foreign securities. For instance, the compliance requirements of the SEC apply equally to employees of U.S.A. companies working in other countries and when trading in U.S.A. securities abroad. In addition, members must comply with the local laws and regulations of foreign countries[398].

Accounting and disclosure differences among countries and variations in the scope and effectiveness of local securities regulation can sometimes lead to misunderstandings on the part of those participating in foreign markets about the nature and extent of the information available to make investment judgments and about the degree of protection afforded to public investors. Investment professionals should make investors aware of differences in the basis for providing accounting figures; international variations in the timeliness, depth, quality, and comprehensiveness of corporate disclosures; the degree of public protection provided by securities laws and regulations; the general extent of regulatory compliance with laws and regulations; the degree of liquidity of foreign markets; and such other relevant factors as capital or currency controls. It is incumbent upon investment professionals to identify differences in these areas, to consider them in their work, and to inform their clients of any relevant significant difference when discussing investments in foreign markets[399].

It would be unprofessional, for example, for a research analyst to compare financial ratios prepared with figures presented under different accounting standards without examining the significance of these differences and making adjustments to ensure comparability[400].

It would also be unprofessional for a portfolio manager to fail to consider the risks associated with trading in a foreign securities market, if there were no enforced local government, stock exchange, or corporate rules in place concerning the use by insiders of material nonpublic information[401].

---

[398] ibid.
[399] ibid.
[400] ibid.
[401] ibid.

Members should take the necessary action to ensure that in addition to being fully informed of the Code and Standards and the securities laws and regulations of their home country, they also have appropriate knowledge of the laws and regulations of all countries in which they trade securities or provide investment advice to others and the place of domicile of the issuers of corporate securities analyzed or traded. Members should familiarize themselves with the accounting and disclosure standards, the extent of compliance, market liquidity, and other relevant characteristics of the home countries of the issuers of the corporate securities they analyze[402].

Members should communicate to clients any relevant significant differences in regulatory, accounting, and disclosure requirements, compliance, and other market characteristics, when advising them about investments in foreign markets[403].

5.5. PROFESSIONALISM AND SERVICE TO THE INVESTING PUBLIC

AIMR's goal is to support fair treatment for the investing public and to encourage high ethical and professional standards in the investment industry. The financial analyst who is in a position to represent his profession in dealings with representatives of corporations, governments, regulatory bodies, and industry groups should encourage fair treatment of the investing public and the adoption of high ethical and professional standards in the field of investment management and research. An ethical and proficient industry is in the best interests of the investing public that relies on the profession's advice and management services. It is also in the best interests of investment professionals who seek to compete fairly on the basis of their professional abilities[404].

During the career of an investment professional, he may be placed in a position to represent the views of investors or the investment profession to legislators, government departments or agencies, other regulatory or professional bodies, members of the press, or the general public. In these representations, he should encourage fair treatment for investors. The monetary policies of central banks, the economic policies and securities laws and regulations of governments, corporate disclosure standards, and financial accounting standards are all set with a view to

---

[402] ibid.
[403] ibid.
[404] ibid, pp.185.

achieve many objectives and involve balancing the varied interests of many parties. However, any appropriately balanced set of policies and rules that is socially just and economically sound should accord fair treatment to the providers of investment capital[405].

The financial analyst should be careful to ensure that, in his professional advocacy representations on these issues, he is acting in the best interests of the investing public and not merely in the narrow interests of the financial industry or those engaged in the profession of financial analysis[406].

[405] ibid.
[406] ibid.

EMPIRICAL RESEARCH

The questions below are replied by 38 investment advisors and portfolio managers, who are employed in several financial intermediaries. The aim of this empirical research is to see what is the situation in Turkey. By asking these questions to the people, who are employed in this industry, we tried to learn:

- whether they comply with the rules and regulations,
- the pitfalls of the regulatory framework according to them and,
- their recommendations and opinions about the problems or pitfalls of the current practices in Turkey.

In addition, some questions, which are also given below, prepared for the clients and replied by 18 clients. The aim here is to get the opinions and recommendations of the clients, who are on the other side of the subject.

Questions for the Investment Advisors and Portfolio Managers:

1. Do you have the knowledge of the regulatory framework that regulates your job?
100 % of the Investment Advisors and Portfolio Managers that answer that question said YES.

2. Does your recommendations based on reliable documents, supportive reports and analysis?
100 % of the Investment Advisors and Portfolio Managers that answer that question said YES.

3. Do you make sure that the most appropriate investment decisions are taken by clients with respect to their monetary position, available investment instruments, liquidity and risk and return preferences of them?
100 % of the Investment Advisors and Portfolio Managers that answer that question said YES.

4. Do you guarantee a predetermined return to your clients?
100 % of the Investment Advisors and Portfolio Managers that answer that question said NO.

5. Does your clients' interests prior to yours, if your and your clients' interests conflict?

100 % of the Investment Advisors and Portfolio Managers that answer that question said YES.

6. Do you sign a contract with your clients before you begin to work with them?

100 % of the Investment Advisors and Portfolio Managers that answer that question said YES.

7. In this contract (if exists), do the commissions or fees that will be charged mentioned?

100 % of the Investment Advisors and Portfolio Managers that answer that question said NO. The reason is that; the fees or commissions changes with respect to the size of the portfolio.

8. Do you inform your clients about the legal framework that regulates your activities?

100 % of the Investment Advisors and Portfolio Managers that answer that question said YES, but if demanded.

9. How do you measure your performance? What are the measures that you compare your performance with?

The employer measures the sales performance. There are predetermined targets for each investment instrument and if these targets are exceeded, investment advisors and portfolio managers earn premium.

10. According to you, does the regulatory framework regulating your job sufficient? What are your opinions and recommendations?

The Investment Advisors' and Portfolio Managers' opinions can be summarized as follows: Regulations are not as much detailed as in the other countries that have developed capital markets. But the current regulations are appropriate and sufficient for Turkey. Turkey is an emerging market and investment alternatives are limited in number. So, as the capital markets develop and investment alternatives increase in number, the needed legal framework will follow it.

Questions for the Clients:

1. Do you have knowledge about the Capital Market Law? According to you, does the regulatory framework regulating capital markets sufficient? What are your opinions and recommendations?
Most of the clients (95%) that answered that question said that they have enough (according to them) knowledge about the Capital Market Law. Also, the current regulations are appropriate and sufficient according to them.

2. Do you need an investment manager? What do you expect from investment advisors?
Most of the clients (90%) do not utilize the services offered by the investment advisors and they make their investment decisions by themselves.

Results:

- All of the investment advisors and portfolio managers have the knowledge of the regulatory framework that regulate their job. Also, they comply with the laws and regulations very well. The employer firms regularly monitor whether the staff comply with the laws and regulations.

- In Turkey, regulations about investment management profession and presentation and measurement of performance of investment managers are not as much detailed as in the countries that have developed capital markets, such as U.S.A..

- In Turkey, the investment managers or investment advisors are not exist according to the strict definitions of these professions. There are of course a number of staff exist in the financial institutions providing some of the services included in the job description of the investment managers or investment advisors. But they cannot be called as 'investment advisors'.

- Performance measurement does not exist in Turkey. That is the major pitfall of the Turkish system.

- Most of the clients do not utilize the services offered by the investment advisors and they make their own investment decisions by themselves.

CONCLUSION

In order to establish internationally acceptable standards of financial reporting, number of national or international accounting institutions spent efforts. Major ones of these institutions, their workings, successes and failures are discussed in detail above. It can be seen that internationalization of accounting is proceeding apace, but this process is along complex and uncertain paths. Firstly and most importantly, each country should establish uniformity in its own accounting practices and internationalization of accounting will then follow it. Unfortunately, in Turkey, the accounting practices are not uniform yet.

The efforts spend to make 'accounting practices' and 'preparation and presentation of financial statements' more uniform are advantageous for investment managers, because the financial statements are utilized by investment managers in their decision making process. The uniformity of these statements make them more reliable and this leads investment managers to make better investment decisions. Also, by eliminating the wrong investment decisions only because of the utilization of unreliable financial statements as a source of information, uniformity provides better picture of the performance of the investment managers.

There are also efforts to identify a clear set of guidelines that would become a model for use by investment managers and to bring about an awareness and a standardization with regard to the measurement and presentation of performance in the industry. There is a tendency for investment managers to manipulate the data to show their best results, because there is considerable latitude in how performance is calculated and in how it is presented and this leads to confusion and inconsistency. So, firstly and most importantly investment managers themselves must agree that reporting standards have to be improved.

Also, according to emprical research, in Turkey, regulations about investment management profession and presentation and measurement of performance of the investment managers are not as much detailed as in the U.S.A.. That is because, Turkey is an emerging market and the investment alternatives are limited in number. Also, in fact, in Turkey the investment managers or investment advisors are not exist according to the definition of these professions. There are of course a number of staff exist in the financial institutions providing some of the services included

in the job description of the investment managers or investment advisors. As the investor demand for the other services- that are not yet exist- appears and the number of investment alternatives available increase, the needed legal framework will follow it.

BIBLIOGRAPHY

Books:

1. AIMR, 'Financial Reporting In The 1990s And Beyond', 1993.

2. AIMR, 'Performance Evaluation, Benchmarks, and Attribution Analysis', 1995.

3. AIMR, 'Performance Presentation Standards with commentary and interpretation', 1993.

4. AIMR, 'Performance Reporting for Investment Managers: Applying the AIMR Performance Presentation Standards', 1991.

5. AIMR, 'Standards Of Practice Handbook, The Code Of Ethics And The Standards Of Professional Conduct, With Commentary And Interpretation', 6.ed., 1992.

6. Akdoğan, Nalan; Orhan Sevilengül, 'Tekdüzen Muhasebe Sistemi Uygulaması', İstanbul Serbest Muhasebeci Mali Müşavirler Odası Yayınları, Yayın No:7, pp.5.

7. Brigham, Eugene F., 'Fundamentals Of Financial Management', 6.ed., The Dryden Press, 1992.

8. Commission Of The European Communities, 'Securities Markets, Community Measures Adopted Or Proposed Together With Their Extension To The European Economic Area, Situation As Of June 1993', Luxembourg: Office For Official Publications Of The European Communities, 1993.

9. Durmuş, Ahmet Hayri, 'Uluslararası Muhasebe Standartları (1-31)', Türkiye Muhasebe Uzmanları Derneği Yayını No.7, İstanbul 1992.

10. Erdikler-Eratalar YMM A.Ş., Arthur Andersen & Co., SC; Yapı ve Kredi Bankası A.Ş., 'Doing Business in Turkey'.

11. Francis, Jack Clark and Richard W. Taylor, 'Schaum's Outline Series: Theory and Problems of Investments', McGraw - Hill, Inc., 1992.

12. Horwitz, Bertrand, 'Financial Reporting Rules And Corporate Decisions' Contemporary Studies In Economic And Financial Analysis; v.36, 1982.

13. İMKB Araştırma Müdürlüğü, 'Uluslararası Sermaye Hareketlerinde Portföy Yatırımları ve Türkiye', Araştırma Yayınları No:3, Kasım 1994.

14. Karslı, Muharrem, 'Sermaye Piyasası,Borsa, Menkul Kıymetler', İrfan Yayımcılık ve Tic., 4. Baskı, 1989.

15. Kocaman, Berna Ç., 'Yatırım Teorisinde Modern Gelişmeler ve İstanbul Menkul Kıymetler Borsasında Bazı Değerlendirme ve Gözlemler', İMKB Araştırma Yayınları No:5, Haziran 1995.

16. Meigs, Robert F. and Walter B. Meigs, 'Accounting: The Basis For Business Decisions', Mc Graw-Hill Publishing Company, 8.ed., 1990.

17. Mishkin, Frederic S., 'The Economics of Money, Banking, and Financial Markets', Harper Collins College Publishers, 4.ed., 1995.

18. Rosen, Harvey S., 'Public Finance', 3.ed., Richard D. Irwin, Inc., 1992.

19. Seyidoğlu, Halil, 'Uluslararası Finans', Güzem Yayınları, No: 8, 1994.

20. Şensoy, Necdet, 'Selected Topics on Turkish Tax Accounting', Marmara Üniversitesi Yayın No: 550, İktisadi ve İdari Bilimler Fakültesi Yayın No: 397, İstanbul, 1994.

21. The Institute of Chartered Financial Analysts and the Financial Analysts Federation, 'Performance Measurement: Setting the Standards, Interpreting the Numbers', 1989.

22. TMUDESK, 'Türkiye Muhasebe Standartları 1997', TÜRMOB Yayın No: 32, TMUDESK Seri No: 1, 1997.

23. TÜRMOB, 'Mecburi Meslek Kararları Önerileri', 7. Olağan Genel Kurul, Ankara, 1996.

24. Ünal, Targan, 'Gelişen Borsalarda Kurumsal Yatırımcılar: Türkiye Örneği, Sorunlar ve Çözüm Önerileri', İMKB Araştırma Yayınları No:7, Temmuz 1995.

25. Weston, J. Fred and Eugene F. Brigham, 'Essentials Of Managerial Finance', 10.ed., The Dryden Press, 1992.

26. Vurgun, Kudret, 'Uluslararası Piyasalara Erişim (ADR_GDR) ve Türk Sermaye Piyasasına Alternatif Öneriler', İMKB Araştırma Yayınları No:4, Kasım 1994.

Articles:

1. Ashton, D.J., 'The Power of Tests of Fund Manager Performance', Journal of Business Finance and Accounting, 23(1), January 1996.

2. Ball, Ray, 'Making Accounting More International: Why, How, And How Far Will It Go?', The Bank Of America, Journal Of Applied Corporate Finance, Fall 1995, Volume 8, Number 3.

3. Bank Administration Institute, 'Measuring the Investment Performance of Pension Funds', 1968.

4. Benston, G., 'Required Disclosure And The Stock Market: An Evaluation Of The Securities And Exchange Act Of 1934', American Economic Review 63, 1973.

5. Brooks, M.J., 'Financial Accounting Principles And Management Accounting', Journal of Management Accounting, October 1988 (66/9).

6. Cahan, Steven F., 'Ethics and Disclosure in the Savings and Loan Industry', Business and Professional Ethics Journal, vol.11, Nos. 3 & 4, 1992.

7. Ciccotello, Conrad S. and C. Terry Grant, 'Equity Fund Size and Growth: Implications for Performance and Selection', The Journal of Individual Financial Management, Vol. 5, No.1, JAI Press Inc., 1996.

8. Fisher, Lawrence, 'Outcomes for Random Investments in Common Stocks Listed on the New York Stock Exchange', Journal of Business, April 1965.

9. Fisher, Lawrence, 'Measuring Rates of Return', Measuring the Investment Performance of Pension Funds for the Purpose of Interfund Comparisons, Bank Administration Institute, 1968.

10. Gaa, James C. and Itzhak Krinsky, 'The Demand for Regulation of Financial Disclosures', Journal of Business Ethics 7(1988).

11. IFR Publishing, 'Regulators Praise Improvements in Disclosure', Financial Products Issue 54, No. 13, 1996.

12. MCB University Press, 'Presentation of Financial Information', January 1992 (109/1181).

13. The Ford Foundation, 'Managing Education Endowments', New York, 1968.

14. Smith, Malcolm and Richard Taffler, 'The Incremental Effect of Narrative Accounting Information in Corporate Annual Reports', Journal of Business Finance and Accounting, 22(8), December 1995.

15. Watts, Ross L. and Jerold Zimmerman, 'Towards a Positive Theory of the Determination of Accounting Standards', Accounting Review (Jan 1978).

Laws:

1. İMKB, 'Hissedarların Elinde Bulunan Hisse Senetlerini Halka Arzetmelerine İlişkin Esaslar Tebliği', İMKB Mevzuat Serisi, Yayın No:6, Kasım 1994.

2. İMKB, 'Hisse Senetlerinin Kurul Kaydına Alınmasına İlişkin Esaslar Tebliği', İMKB Mevzuat Serisi, Yayın No:5, Kasım 1994.

3. İMKB, 'Menkul Kıymetler Borsaları Hakkında Kanun Hükmünde Karaname', İMKB Mevzuat Serisi, Yayın No:2, Temmuz 1995.

4. İMKB, 'Özel Durumları Kamuya Açıklanmasına İlişkin Tebliğ', İMKB Mevzuat Serisi, Yayın No:12, Kasım 1994.

5. İMKB, 'Portföy Yöneticiliği Faaliyetine ve Bu Faaliyette Bulunacak Kurumlara İlişkin Esaslar Tebliği', İMKB Mevzuat Serisi, Yayın No:30, Şubat 1995.

6. İMKB, 'Sermaye Piyasasında Ara Mali Tablolara İlişkin İlke ve Kurallar Hakkında Tebliğ', İMKB Mevzuat Serisi, Yayın No:17, Kasım 1994.

7. İMKB, 'Sermaye Piyasasında Mali Tablo ve Raporlara İlişkin İlke ve Kurallar Hakkında Tebliğ ve Ek Tebliğ', İMKB Mevzuat Serisi, Yayın No:15, Kasım 1994.

8. İMKB, 'Sermaye Piyasası Kanunu', İMKB Mevzuat Serisi, Yayın No:1, Temmuz 1995.

9. İMKB, 'Sermaye Piyasası Kanununa Tabi Ortaklık ve Kuruluşların Mali Tablo ve Rapor Düzenleme, Kamuya Duyurma ve Bağımsız Denetleme Yükümlülüklerinin Belirlenmesine İlişkin Genel Açıklama Tebliği', İMKB Mevzuat Serisi, Yayın No:19, Kasım 1994.

10. İMKB, 'Sermaye Piyasasında Konsolide Mali Tablolara İlişkin İlke ve Kurallar Hakkında Tebliğ', İMKB Mevzuat Serisi, Yayın No:18, Kasım 1994.

11. İMKB, 'Standart Genel Hesap Planı ve Planın Kullanım Esasları Hakkında Tebliğ', İMKB Mevzuat Serisi, Yayın No:16, Kasım 1994.

12. İMKB, 'Yatırım Danışmanlığı Faaliyetine ve Bu Faaliyette Bulunacak Kurumlara İlişkin Esaslar Tebliği', İMKB Mevzuat Serisi, Yayın No:31, Şubat 1995.