

misunderstandings with respect to the audit. In some countries, however, the objective and scope of an audit and the responsibilities of management and of the auditor may be sufficiently established by law, that is, they prescribe the matters described in paragraph 10. Although in these circumstances paragraph 11 permits the auditor to include in the engagement letter only reference to the fact that relevant law or regulation applies and that management acknowledges and understands its responsibilities as set out in paragraph 6(b), the auditor may nevertheless consider it appropriate to include the matters described in paragraph 10 in an engagement letter for the information of management.

#### Form and Content of the Audit Engagement Letter

**A24** The form and content of the audit engagement letter may vary for each entity. Information included in the audit engagement letter on the auditor's responsibilities may be based on ISA (UK) 200 (Revised June 2016).<sup>17</sup> Paragraphs 6(b) and 12 of this ISA (UK) deal with the description of the responsibilities of management. In addition to including the matters required by paragraph 10, an audit engagement letter may make reference to, for example:

- Elaboration of the scope of the audit, including reference to applicable legislation, regulations, ISAs (UK), and ethical and other pronouncements of professional bodies to which the auditor adheres.
- The form of any other communication of results of the audit engagement.
- The requirement for the auditor to communicate key audit matters in the auditor's report in accordance with ISA (UK) 701.<sup>18</sup>
- The fact that because of the inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with ISAs (UK).
- Arrangements regarding the planning and performance of the audit, including the composition of the audit team.
- The expectation that management will provide written representations (see also paragraph A13).
- The expectation that management will provide access to all information of which management is aware that is relevant to the preparation of the financial statements, including an expectation that management will provide access to information relevant to disclosures.
- The agreement of management to make available to the auditor draft financial statements, including all information relevant to their preparation, whether obtained from within or outside of the general and subsidiary ledgers (including all information relevant to the preparation of disclosures), and the other information,<sup>19</sup> if any, in time to allow the auditor to complete the audit in accordance with the proposed timetable.
- The agreement of management to inform the auditor of facts that may affect the financial statements, of which management may become aware during the period from the date of the auditor's report to the date the financial statements are issued.

<sup>17</sup> ISA (UK) 200 (Revised June 2016), paragraphs 3–9.

<sup>18</sup> ISA (UK) 701, *Communicating Key Audit Matters in the Independent Auditor's Report*.

<sup>19</sup> As defined in ISA (UK) 720 (Revised June 2016), *The Auditor's Responsibilities Relating to Other Information*.

- The basis on which fees are computed and any billing arrangements.
- A request for management to acknowledge receipt of the audit engagement letter and to agree to the terms of the engagement outlined therein.

When the auditor is not required to communicate key audit matters, it may be helpful for the auditor to make reference in the terms of the audit engagement to the possibility of communicating key audit matters in the auditor's report and, in certain jurisdictions, it may be necessary for the auditor to include a reference to such possibility in order to retain the ability to do so. **A25**

When relevant, the following points could also be made in the audit engagement letter: **A26**

- Arrangements concerning the involvement of other auditors and experts in some aspects of the audit.
- Arrangements concerning the involvement of internal auditors and other staff of the entity.
- Arrangements to be made with the predecessor auditor, if any, in the case of an initial audit.
- A reference to, and description of, the auditor's responsibilities under law, regulation or relevant ethical requirements that address reporting identified or suspected non-compliance with laws and regulations to an appropriate authority outside the entity.
- Any restriction of the auditor's liability when such possibility exists.
- A reference to any further agreements between the auditor and the entity.
- Any obligations to provide audit working papers to other parties.

An example of an audit engagement letter is set out in Appendix 1.<sup>19a</sup>

#### Audits of Components

When the auditor of a parent entity is also the auditor of a component, the factors that may influence the decision whether to send a separate audit engagement letter to the component include the following: **A27**

- Who appoints the component auditor;
- Whether a separate auditor's report is to be issued on the component;
- Legal requirements in relation to audit appointments;
- Degree of ownership by parent; and
- Degree of independence of the component management from the parent entity.

#### Responsibilities of Management Prescribed by Law or Regulation (Ref: Para. 11–12)

If, in the circumstances described in paragraphs A23 and A29, the auditor concludes that it is not necessary to record certain terms of the audit engagement in an audit engagement letter, the auditor is still required by paragraph 11 to seek the written agreement from management that it acknowledges and understands that it has the responsibilities set out in paragraph 6(b). However, in accordance with paragraph 12, such written **A28**

<sup>19a</sup> The example letter in Appendix 1 has not been tailored for the UK.

## Appendix 1

(Ref: Para. A24–26)

### Example of an Audit Engagement Letter

The example letter in this Appendix has not been tailored for the UK.

The following is an example of an audit engagement letter for an audit of general purpose financial statements prepared in accordance with International Financial Reporting Standards. This letter is not authoritative but is intended only to be a guide that may be used in conjunction with the considerations outlined in this ISA. It will need to be varied according to individual requirements and circumstances. It is drafted to refer to the audit of financial statements for a single reporting period and would require adaptation if intended or expected to apply to recurring audits (see paragraph 13 of this ISA). It may be appropriate to seek legal advice that any proposed letter is suitable.

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To the appropriate representative of management or those charged with governance of ABC Company:<sup>1-a</sup>

*[The objective and scope of the audit]*

You<sup>2-a</sup> have requested that we audit the financial statements of ABC Company, which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies. We are pleased to confirm our acceptance and our understanding of this audit engagement by means of this letter.

The objectives of our audit are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with International Standards on Auditing (ISAs) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

*[The responsibilities of the auditor]*

We will conduct our audit in accordance with ISAs. Those standards require that we comply with ethical requirements. As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is

<sup>1-a</sup> The addressees and references in the letter would be those that are appropriate in the circumstances of the engagement, including the relevant jurisdiction. It is important to refer to the appropriate persons – see paragraph A22.

<sup>2-a</sup> Throughout this letter, references to “you,” “we,” “us,” “management,” “those charged with governance” and “auditor” would be used or amended as appropriate in the circumstances.

sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.<sup>3-a</sup> However, we will communicate to you in writing concerning any significant deficiencies in internal control relevant to the audit of the financial statements that we have identified during the audit.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

Because of the inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with ISAs.

*[The responsibilities of management and identification of the applicable financial reporting framework (for purposes of this example it is assumed that the auditor has not determined that the law or regulation prescribes those responsibilities in appropriate terms; the descriptions in paragraph 6(b) of this ISA are therefore used).]*

Our audit will be conducted on the basis that [management and, where appropriate, those charged with governance]<sup>4-a</sup> acknowledge and understand that they have responsibility:

- (a) For the preparation and fair presentation of the financial statements in accordance with International Financial Reporting Standards;<sup>5-a</sup>
- (b) For such internal control as [management] determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and

<sup>3-a</sup> This sentence would be modified, as appropriate, in circumstances when the auditor also has responsibility to issue an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements.

<sup>4-a</sup> Use terminology as appropriate in the circumstances.

<sup>5-a</sup> Or, if appropriate, “For the preparation of financial statements that give a true and fair view in accordance with International Financial Reporting Standards.”

**21R-1** For audits of financial statements of public interest entities, the engagement quality control reviewer, on performing an engagement quality control review,<sup>4d</sup> shall also consider the following elements:

- (a) The independence of the firm from the entity;
- (b) The significant risks which are relevant to the audit and which the key audit partner(s) has identified during the performance of the audit and the measures that the key audit partner(s) has taken to adequately manage those risks;
- (c) The reasoning of the key audit partner(s), in particular with regard to the level of materiality and the significant risks referred to in paragraph 21R-1(b);
- (d) Any request for advice to external experts and the implementation of such advice;
- (e) The nature and scope of the corrected and uncorrected misstatements in the financial statements that were identified during the carrying out of the audit;
- (f) The subjects discussed with the audit committee and management and/or supervisory bodies of the entity;
- (g) The subjects discussed with competent authorities<sup>4e</sup> and, where applicable, with other third parties; and
- (h) Whether the documents and information selected from the file by the engagement quality control reviewer support the opinion of the key audit partner(s) as expressed in the draft of the auditor's report and the additional report to the audit committee.<sup>4f</sup>

**21R-2** The engagement quality control reviewer shall discuss the results of the review, including the elements assessed in paragraph 21R-1, with the key audit partner(s).

#### *Differences of Opinion*

- 22** If differences of opinion arise within the engagement team, with those consulted or, where applicable, between the engagement partner and the engagement quality control reviewer, the engagement team shall follow the firm's policies and procedures for dealing with and resolving differences of opinion.

#### *Monitoring*

- 23** An effective system of quality control includes a monitoring process designed to provide the firm with reasonable assurance that its policies and procedures relating to the system of quality control are relevant, adequate, and operating effectively. The engagement partner shall consider the results of the firm's monitoring process as evidenced in the latest information circulated by the firm and, if applicable, other network firms and whether deficiencies noted in that information may affect the audit engagement. (Ref: Para A33–A35)

<sup>4d</sup> The requirement for an engagement quality control review is established in ISQC (UK) 1 (Revised June 2016), paragraph 36R-1.

<sup>4e</sup> In the UK, the competent authority designated by law is the Financial Reporting Council.

<sup>4f</sup> The requirements for these reports are set out respectively in ISA (UK) 700 (Revised June 2016), *Forming an Opinion and Reporting on Financial Statements* and ISA (UK) 260 (Revised June 2016), *Communication with Those Charged with Governance*.

#### *Documentation*

The auditor shall include in the audit documentation:<sup>5</sup>

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- (a) Issues identified with respect to compliance with relevant ethical requirements and how they were resolved.
- (b) Conclusions on compliance with independence requirements that apply to the audit engagement, and any relevant discussions with the firm that support these conclusions.
- (c) Conclusions reached regarding the acceptance and continuance of client relationships and audit engagements.
- (d) The nature and scope of, and conclusions resulting from, consultations undertaken during the course of the audit engagement. (Ref: Para. A36)

The auditor shall include in the audit documentation:

24D-1

- (a) All significant threats to the firm's independence as well as the safeguards applied to mitigate those threats; and
- (b) Those matters it is required to assess before accepting or continuing a statutory audit engagement in accordance with ISQC (UK) 1 (Revised June 2016).

The engagement quality control reviewer shall document, for the audit engagement reviewed, that:

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- (a) The procedures required by the firm's policies on engagement quality control review have been performed;
- (b) The engagement quality control review has been completed on or before the date of the auditor's report; and
- (c) The reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions it reached were not appropriate.

For audits of financial statements of public interest entities, the engagement quality control reviewer shall also record:

25R-1

- (a) The oral and written information provided by the key audit partner(s) to support the significant judgments as well as the main findings of the audit procedures carried out and the conclusions drawn from those findings, whether or not at the request of the engagement quality control reviewer; and
- (b) The opinions of the key audit partner(s), as expressed in the draft of the reports required by ISA (UK) 260 (Revised June 2016) and ISA (UK) 700 (Revised June 2016).

For audits of financial statements of public interest entities, the auditor and the engagement quality control reviewer shall keep a record of the results of the engagement quality control review, together with the considerations underlying those results, in the audit documentation.

25R-2

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<sup>5</sup> ISA (UK) 230 (Revised June 2016), *Audit Documentation*, paragraphs 8–11, and paragraph A6.

action, which may include eliminating the activity or interest that creates the threat, or withdrawing from the audit engagement, where withdrawal is possible under applicable law or regulation.

#### Considerations Specific to Public Sector Entities

- A7** Statutory measures may provide safeguards for the independence of public sector auditors. However, public sector auditors or audit firms carrying out public sector audits on behalf of the statutory auditor may, depending on the terms of the mandate in a particular jurisdiction, need to adapt their approach in order to promote compliance with the spirit of paragraph 11. This may include, where the public sector auditor's mandate does not permit withdrawal from the engagement, disclosure through a public report, of circumstances that have arisen that would, if they were in the private sector, lead the auditor to withdraw.

#### Acceptance and Continuance of Client Relationships and Audit Engagements (Ref: Para. 12)

- A8** ISQC (UK) 1 (Revised June 2016) requires the firm to obtain information considered necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client.<sup>6</sup> Information such as the following assists the engagement partner in determining whether the conclusions reached regarding the acceptance and continuance of client relationships and audit engagements are appropriate:

- The integrity of the principal owners, key management and those charged with governance of the entity;
- Whether the engagement team is competent to perform the audit engagement and has the necessary capabilities, including time and resources;
- Whether the firm and the engagement team can comply with relevant ethical requirements; and
- Significant matters that have arisen during the current or previous audit engagement, and their implications for continuing the relationship.

- A8a** Law, regulation, or relevant ethical requirements<sup>7</sup> may require the auditor to request, prior to accepting the engagement, the predecessor auditor to provide known information regarding any facts or circumstances that, in the predecessor auditor's judgment, the auditor needs to be aware of before deciding whether to accept the engagement. In some circumstances, the predecessor auditor may be required, on request by the proposed successor auditor, to provide information regarding identified or suspected non-compliance with laws and regulations to the proposed successor auditor.<sup>7a</sup> For example, where the predecessor auditor has withdrawn from the engagement as a result of identified or suspected non-

<sup>6</sup> ISQC (UK) 1 (Revised June 2016), paragraph 27(a).

<sup>7</sup> See, for example, Sections 210.14 of the IESBA Code.

In the UK, the relevant guidance on proposed communications with a predecessor auditor is provided by the pronouncements relating to the work of auditors issued by the auditor's relevant professional body.

<sup>7a</sup> In the UK, the predecessor auditor is required to provide the successor statutory auditor with access to all relevant information concerning the entity, including information concerning the most recent audit. This would include non-compliance with laws and regulations. See ISQC (UK) 1 (Revised June 2016), Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and other Assurance and Related Services Engagements, paragraph 28D-1.

compliance with laws and regulations, the IESBA Code requires that the predecessor auditor, on request by a proposed successor auditor, provides all such facts and other information concerning such non-compliance that, in the predecessor auditor's opinion, the proposed successor auditor needs to be aware of before deciding whether to accept the audit appointment.<sup>8</sup>

#### Considerations Specific to Public Sector Entities (Ref: Para. 12–13)

In the public sector, auditors may be appointed in accordance with statutory procedures. Accordingly, certain of the requirements and considerations regarding the acceptance and continuance of client relationships and audit engagements as set out in paragraphs 12, 13 and A8 may not be relevant. Nonetheless, information gathered as a result of the process described may be valuable to public sector auditors in performing risk assessments and in carrying out reporting responsibilities. **A9**

#### Assignment of Engagement Teams (Ref: Para. 14)

An engagement team includes a person using expertise in a specialized area of accounting or auditing, whether engaged or employed by the firm, if any, who performs audit procedures on the engagement. However, a person with such expertise is not a member of the engagement team if that person's involvement with the engagement is only consultation. Consultations are addressed in paragraph 18, and paragraph A21–A22. **A10**

When considering the appropriate competence and capabilities expected of the engagement team as a whole, the engagement partner may take into consideration such matters as the team's: **A11**

- Understanding of, and practical experience with, audit engagements of a similar nature and complexity through appropriate training and participation.
- Understanding of professional standards and applicable legal and regulatory requirements.
- Technical expertise, including expertise with relevant information technology and specialized areas of accounting or auditing.
- Knowledge of relevant industries in which the client operates.
- Ability to apply professional judgment.
- Understanding of the firm's quality control policies and procedures.

#### Considerations Specific to Public Sector Entities

In the public sector, additional appropriate competence may include skills that are necessary to discharge the terms of the audit mandate in a particular jurisdiction. Such competence may include an understanding of the applicable reporting arrangements, including reporting to the legislature or other governing body or in the public interest. The wider scope of a public sector audit may include, for example, some aspects of performance auditing or a comprehensive assessment of **A12**

<sup>8</sup> See, for example, Sections 225.31 of the IESBA Code.

In the UK, the auditor has regard to any specific requirements of the auditor's relevant professional body.

compliance with law, regulation or other authority and preventing and detecting fraud and corruption.

### **Engagement Performance**

#### *Direction, Supervision and Performance* (Ref: Para. 15(a))

**A13** Direction of the engagement team involves informing the members of the engagement team of matters such as:

- Their responsibilities, including the need to comply with relevant ethical requirements, and to plan and perform an audit with professional skepticism as required by ISA (UK) 200 (Revised June 2016).<sup>9</sup>
- Responsibilities of respective partners where more than one partner is involved in the conduct of an audit engagement.
- The objectives of the work to be performed.
- The nature of the entity's business.
- Risk-related issues.
- Problems that may arise.
- The detailed approach to the performance of the engagement.

Discussion among members of the engagement team allows less experienced team members to raise questions with more experienced team members so that appropriate communication can occur within the engagement team.

**A14** Appropriate teamwork and training assist less experienced members of the engagement team to clearly understand the objectives of the assigned work.

**A15** Supervision includes matters such as:

- Tracking the progress of the audit engagement.
- Considering the competence and capabilities of individual members of the engagement team, including whether they have sufficient time to carry out their work, whether they understand their instructions, and whether the work is being carried out in accordance with the planned approach to the audit engagement.
- Addressing significant matters arising during the audit engagement, considering their significance and modifying the planned approach appropriately.
- Identifying matters for consultation or consideration by more experienced engagement team members during the audit engagement.

### *Reviews*

#### *Review Responsibilities* (Ref: Para. 16)

**A16** Under ISQC (UK) 1 (Revised June 2016), the firm's review responsibility policies and procedures are determined on the basis that work of less experienced team members is reviewed by more experienced team members.<sup>10</sup>

<sup>9</sup> ISA (UK) 200 (Revised June 2016), *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing (UK)*, paragraph 15.

<sup>10</sup> ISQC (UK) 1 (Revised June 2016), paragraph 33.

A review consists of consideration whether, for example:

A17

- The work has been performed in accordance with professional standards and applicable legal and regulatory requirements;
- Significant matters have been raised for further consideration;
- Appropriate consultations have taken place and the resulting conclusions have been documented and implemented;
- There is a need to revise the nature, timing and extent of work performed;
- The work performed supports the conclusions reached and is appropriately documented;
- The evidence obtained is sufficient and appropriate to support the auditor's report; and
- The objectives of the engagement procedures have been achieved.

#### *The Engagement Partner's Review of Work Performed* (Ref: Para. 17)

Timely reviews of the following by the engagement partner at appropriate stages during the engagement allow significant matters to be resolved on a timely basis to the engagement partner's satisfaction on or before the date of the auditor's report: **A18**

- Critical areas of judgment, especially those relating to difficult or contentious matters identified during the course of the engagement;
- Significant risks; and
- Other areas the engagement partner considers important.

The engagement partner need not review all audit documentation, but may do so. However, as required by ISA (UK) 230 (Revised June 2016), the partner documents the extent and timing of the reviews.<sup>11</sup>

An engagement partner taking over an audit during the engagement may apply the review procedures as described in paragraph A18 to review the work performed to the date of a change in order to assume the responsibilities of an engagement partner. **A19**

#### *Considerations Relevant Where a Member of the Engagement Team with Expertise in a Specialized Area of Accounting or Auditing Is Used* (Ref: Para. 15–17)

Where a member of the engagement team with expertise in a specialized area of accounting or auditing is used, direction, supervision and review of that engagement team member's work may include matters such as: **A20**

- Agreeing with that member the nature, scope and objectives of that member's work; and the respective roles of, and the nature, timing and extent of communication between that member and other members of the engagement team.
- Evaluating the adequacy of that member's work including the relevance and reasonableness of that member's findings or conclusions and their consistency with other audit evidence.

<sup>11</sup> ISA (UK) 230 (Revised June 2016), paragraph 9(c).

## Introduction

### *Scope of this ISA (UK)*

- 1 This International Standard on Auditing (UK) (ISA (UK)) deals with the auditor's responsibility to prepare audit documentation for an audit of financial statements. The Appendix lists other ISAs (UK) that contain specific documentation requirements and guidance. The specific documentation requirements of other ISAs (UK) do not limit the application of this ISA (UK). Law or regulation may establish additional documentation requirements.

### *Nature and Purposes of Audit Documentation*

- 2 Audit documentation that meets the requirements of this ISA (UK) and the specific documentation requirements of other relevant ISAs (UK) provides:
  - (a) Evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor;<sup>1</sup> and
  - (b) Evidence that the audit was planned and performed in accordance with ISAs (UK) and applicable legal and regulatory requirements.
- 3 Audit documentation serves a number of additional purposes, including the following:
  - Assisting the engagement team to plan and perform the audit.
  - Assisting members of the engagement team responsible for supervision to direct and supervise the audit work, and to discharge their review responsibilities in accordance with ISA (UK) 220 (Revised June 2016).<sup>2</sup>
  - Enabling the engagement team to be accountable for its work.
  - Retaining a record of matters of continuing significance to future audits.
  - Enabling the conduct of quality control reviews and inspections in accordance with ISQC (UK) 1 (Revised June 2016)<sup>3</sup> or national requirements that are at least as demanding.<sup>4</sup>
  - Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

### *Effective Date*

- 4 This ISA (UK) is effective for audits of financial statements for periods commencing on or after 17 June 2016. Earlier adoption is permitted.

<sup>1</sup> ISA (UK) 200 (Revised June 2016), *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing (UK)*, paragraph 11.

<sup>2</sup> ISA (UK) 220 (Revised June 2016), *Quality Control for an Audit of Financial Statements*, paragraphs 15–17.

<sup>3</sup> ISQC (UK) 1 (Revised June 2016), *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*, paragraphs 32–33, 35–38, and 48.

<sup>4</sup> ISA (UK) 220 (Revised June 2016), paragraph 2.

## Objective

The objective of the auditor is to prepare documentation that provides: 5

- (a) A sufficient and appropriate record of the basis for the auditor's report; and
- (b) Evidence that the audit was planned and performed in accordance with ISAs (UK) and applicable legal and regulatory requirements.

## Definitions

For purposes of the ISAs (UK), the following terms have the meanings attributed below: 6

- (a) Audit documentation – The record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached (terms such as “working papers” or “workpapers” are also sometimes used).

In the UK, audit documentation shall include all documents, information, records and other data required by ISQC (UK) 1 (Revised June 2016), ISAs (UK) and applicable legal and regulatory requirements.

- (b) Audit file – One or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement.
- (c) Experienced auditor – An individual (whether internal or external to the firm) who has practical audit experience, and a reasonable understanding of:
  - (i) Audit processes;
  - (ii) ISAs (UK) and applicable legal and regulatory requirements;
  - (iii) The business environment in which the entity operates; and
  - (iv) Auditing and financial reporting issues relevant to the entity's industry.

## Requirements

### *Timely Preparation of Audit Documentation*

The auditor shall prepare audit documentation on a timely basis. (Ref: Para. A1) 7

### *Documentation of the Audit Procedures Performed and Audit Evidence Obtained*

#### *Form, Content and Extent of Audit Documentation*

The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand: (Ref: Para. A2–A5, A16–A17) 8

- (a) The nature, timing and extent of the audit procedures performed to comply with the ISAs (UK) and applicable legal and regulatory requirements; (Ref: Para. A6–A7)
- (b) The results of the audit procedures performed, and the audit evidence obtained; and

audit function reports to those charged with governance or an officer with appropriate authority, or if the function reports to management, whether it has direct access to those charged with governance.

- Whether the internal audit function is free of any conflicting responsibilities, for example, having managerial or operational duties or responsibilities that are outside of the internal audit function.
- Whether those charged with governance oversee employment decisions related to the internal audit function, for example, determining the appropriate remuneration policy.
- Whether there are any constraints or restrictions placed on the internal audit function by management or those charged with governance, for example, in communicating the internal audit function's findings to the external auditor.
- Whether the internal auditors are members of relevant professional bodies and their memberships obligate their compliance with relevant professional standards relating to objectivity, or whether their internal policies achieve the same objectives.

**A8** Competence of the internal audit function refers to the attainment and maintenance of knowledge and skills of the function as a whole at the level required to enable assigned tasks to be performed diligently and in accordance with applicable professional standards. Factors that may affect the external auditor's determination include the following:

- Whether the internal audit function is adequately and appropriately resourced relative to the size of the entity and the nature of its operations.
- Whether there are established policies for hiring, training and assigning internal auditors to internal audit engagements.
- Whether the internal auditors have adequate technical training and proficiency in auditing. Relevant criteria that may be considered by the external auditor in making the assessment may include, for example, the internal auditors' possession of a relevant professional designation and experience.
- Whether the internal auditors possess the required knowledge relating to the entity's financial reporting and the applicable financial reporting framework and whether the internal audit function possesses the necessary skills (for example, industry-specific knowledge) to perform work related to the entity's financial statements.
- Whether the internal auditors are members of relevant professional bodies that oblige them to comply with the relevant professional standards including continuing professional development requirements.

**A9** Objectivity and competence may be viewed as a continuum. The more the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors and the higher the level of competence of the function, the more likely the external auditor may make use of the work of the function and in more areas. However, an organizational status and relevant policies and procedures that provide strong support for the objectivity of the internal auditors cannot compensate for the lack of sufficient competence of the internal audit function. Equally, a high level of competence of the internal audit function cannot compensate for an organizational status and policies and procedures that do not adequately support the objectivity of the internal auditors.

Application of a Systematic and Disciplined Approach (Ref: Para. 15(c))

The application of a systematic and disciplined approach to planning, performing, supervising, reviewing and documenting its activities distinguishes the activities of the internal audit function from other monitoring control activities that may be performed within the entity. **A10**

Factors that may affect the external auditor's determination of whether the internal audit function applies a systematic and disciplined approach include the following: **A11**

- The existence, adequacy and use of documented internal audit procedures or guidance covering such areas as risk assessments, work programs, documentation and reporting, the nature and extent of which is commensurate with the size and circumstances of an entity.
- Whether the internal audit function has appropriate quality control policies and procedures, for example, such as those policies and procedures in ISQC (UK) 1 (Revised June 2016)<sup>16</sup> that would be applicable to an internal audit function (such as those relating to leadership, human resources and engagement performance) or quality control requirements in standards set by the relevant professional bodies for internal auditors. Such bodies may also establish other appropriate requirements such as conducting periodic external quality assessments.

Circumstances When Work of the Internal Audit Function Cannot Be Used (Ref: Para. 16)

The external auditor's evaluation of whether the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors, the level of competence of the internal audit function, and whether it applies a systematic and disciplined approach may indicate that the risks to the quality of the work of the function are too significant and therefore it is not appropriate to use any of the work of the function as audit evidence. **A12**

Consideration of the factors in paragraphs A7, A8 and A11 of this ISA (UK) individually and in aggregate is important because an individual factor is often not sufficient to conclude that the work of the internal audit function cannot be used for purposes of the audit. For example, the internal audit function's organizational status is particularly important in evaluating threats to the objectivity of the internal auditors. If the internal audit function reports to management, this would be considered a significant threat to the function's objectivity unless other factors such as those described in paragraph A7 of this ISA (UK) collectively provide sufficient safeguards to reduce the threat to an acceptable level. **A13**

In addition, the IESBA Code<sup>17</sup> states that a self-review threat is created when the external auditor accepts an engagement to provide internal audit services to an audit client, and the results of those services will be used in conducting the audit. This is because of the possibility that the engagement team will use the results of the internal audit service without properly evaluating those results or without exercising the same level of professional skepticism as would be exercised when **A14**

<sup>16</sup> *International Standard on Quality Control (ISQC) (UK) 1 (Revised June 2016), Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements.*

<sup>17</sup> *The International Ethics Standards Board for Accountants' (IESBA) Code of Ethics for Professional Accountants (IESBA Code), Section 290.199.*

- A22** Carrying out procedures in accordance with this ISA (UK) may cause the external auditor to reevaluate the external auditor's assessment of the risks of material misstatement. Consequently, this may affect the external auditor's determination of whether to use the work of the internal audit function and whether further application of this ISA (UK) is necessary.

Communication with Those Charged with Governance  
(Ref: Para. 20)

- A23** In accordance with ISA (UK) 260 (Revised June 2016),<sup>23</sup> the external auditor is required to communicate with those charged with governance an overview of the planned scope and timing of the audit. The planned use of the work of the internal audit function is an integral part of the external auditor's overall audit strategy and is therefore relevant to those charged with governance for their understanding of the proposed audit approach.

### *Using the Work of the Internal Audit Function*

*Discussion and Coordination with the Internal Audit Function*  
(Ref: Para. 21)

- A24** In discussing the planned use of their work with the internal audit function as a basis for coordinating the respective activities, it may be useful to address the following:

- The timing of such work.
- The nature of the work performed.
- The extent of audit coverage.
- Materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures), and performance materiality.
- Proposed methods of item selection and sample sizes.
- Documentation of the work performed.
- Review and reporting procedures.

- A25** Coordination between the external auditor and the internal audit function is effective when, for example:

- Discussions take place at appropriate intervals throughout the period.
- The external auditor informs the internal audit function of significant matters that may affect the function.
- The external auditor is advised of and has access to relevant reports of the internal audit function and is informed of any significant matters that come to the attention of the function when such matters may affect the work of the external auditor so that the external auditor is able to consider the implications of such matters for the audit engagement.

- A26** ISA (UK) 200 (Revised June 2016)<sup>24</sup> discusses the importance of the auditor planning and performing the audit with professional skepticism, including being alert to information that brings into question the reliability of documents and

responses to inquiries to be used as audit evidence. Accordingly, communication with the internal audit function throughout the engagement may provide opportunities for internal auditors to bring matters that may affect the work of the external auditor to the external auditor's attention.<sup>25</sup> The external auditor is then able to take such information into account in the external auditor's identification and assessment of risks of material misstatement. In addition, if such information may be indicative of a heightened risk of a material misstatement of the financial statements or may be regarding any actual, suspected or alleged fraud, the external auditor can take this into account in the external auditor's identification of risk of material misstatement due to fraud in accordance with ISA (UK) 240 (Revised June 2016).<sup>26</sup>

*Procedures to Determine the Adequacy of Work of the Internal Audit Function*  
(Ref: Para. 23– 24)

The external auditor's audit procedures on the body of work of the internal audit function as a whole that the external auditor plans to use provide a basis for evaluating the overall quality of the function's work and the objectivity with which it has been performed. **A27**

The procedures the external auditor may perform to evaluate the quality of the work performed and the conclusions reached by the internal audit function, in addition to reperformance in accordance with paragraph 24, include the following: **A28**

- Making inquiries of appropriate individuals within the internal audit function.
- Observing procedures performed by the internal audit function.
- Reviewing the internal audit function's work program and working papers.

The more judgment involved, the higher the assessed risk of material misstatement, the less the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors, or the lower the level of competence of the internal audit function, the more audit procedures are needed to be performed by the external auditor on the overall body of work of the function to support the decision to use the work of the function in obtaining sufficient appropriate audit evidence on which to base the audit opinion. **A29**

Reperformance  
(Ref: Para. 24)

For purposes of this ISA (UK), reperformance involves the external auditor's independent execution of procedures to validate the conclusions reached by the internal audit function. This objective may be accomplished by examining items already examined by the internal audit function, or where it is not possible to do so, the same objective may also be accomplished by examining sufficient other similar items not actually examined by the internal audit function. Reperformance provides more persuasive evidence regarding the adequacy of the work of the internal audit function compared to other procedures the external auditor may perform in paragraph A28. While it is not necessary for the external auditor to do reperformance in each area of work of the internal audit function that is being used, some reperformance is **A30**

<sup>23</sup> ISA (UK) 260 (Revised June 2016), paragraph 15.

<sup>24</sup> ISA (UK) 200 (Revised June 2016), paragraphs 15 and A18.

<sup>25</sup> ISA (UK) 315 (Revised June 2016), paragraph A116.

<sup>26</sup> ISA (UK) 315 (Revised June 2016), paragraph A11 in relation to ISA (UK) 240 (Revised June 2016), *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*.



- The work of the auditor's expert relates to a significant matter that involves subjective and complex judgments.
- The auditor has not previously used the work of the auditor's expert, and has no prior knowledge of that expert's competence, capabilities and objectivity.
- The auditor's expert is performing procedures that are integral to the audit, rather than being consulted to provide advice on an individual matter.
- The expert is an auditor's external expert and is not, therefore, subject to the firm's quality control policies and procedures.

*The Auditor's Firm's Quality Control Policies and Procedures*  
(Ref: Para. 8(e))

- A11** An auditor's internal expert may be a partner or staff, including temporary staff, of the auditor's firm, and therefore subject to the quality control policies and procedures of that firm in accordance with ISQC (UK) 1<sup>9</sup> or national requirements that are at least as demanding.<sup>10</sup> Alternatively, an auditor's internal expert may be a partner or staff, including temporary staff, of a network firm, which may share common quality control policies and procedures with the auditor's firm.
- A12** An auditor's external expert is not a member of the engagement team and is not subject to quality control policies and procedures in accordance with ISQC (UK) 1.<sup>11</sup> In some jurisdictions, however, law or regulation may require that an auditor's external expert be treated as a member of the engagement team, and may therefore be subject to relevant ethical requirements, including those pertaining to independence, and other professional requirements, as determined by that law or regulation.
- A13** Engagement teams are entitled to rely on the firm's system of quality control, unless information provided by the firm or other parties suggests otherwise.<sup>12</sup> The extent of that reliance will vary with the circumstances, and may affect the nature, timing and extent of the auditor's procedures with respect to such matters as:
- Competence and capabilities, through recruitment and training programs.
  - Objectivity. Auditor's internal experts are subject to relevant ethical requirements, including those pertaining to independence.
  - The auditor's evaluation of the adequacy of the auditor's expert's work. For example, the firm's training programs may provide auditor's internal experts with an appropriate understanding of the interrelationship of their expertise with the audit process. Reliance on such training and other firm processes, such as protocols for scoping the work of auditor's internal experts, may affect the nature, timing and extent of the auditor's procedures to evaluate the adequacy of the auditor's expert's work.
  - Adherence to regulatory and legal requirements, through monitoring processes.
  - Agreement with the auditor's expert.

<sup>9</sup> ISQC (UK) 1 (Revised June 2016), *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*, paragraph 12(f).

<sup>10</sup> ISA (UK) 220 (Revised June 2016), paragraph 2.

<sup>11</sup> ISQC (UK) 1 (Revised June 2016), paragraph 12(f).

<sup>12</sup> ISA (UK) 220 (Revised June 2016), paragraph 4.

Such reliance does not reduce the auditor's responsibility to meet the requirements of this ISA (UK).

*The Competence, Capabilities and Objectivity of the Auditor's Expert*  
(Ref: Para. 9)

The competence, capabilities and objectivity of an auditor's expert are factors that significantly affect whether the work of the auditor's expert will be adequate for the auditor's purposes. Competence relates to the nature and level of expertise of the auditor's expert. Capability relates to the ability of the auditor's expert to exercise that competence in the circumstances of the engagement. Factors that influence capability may include, for example, geographic location, and the availability of time and resources. Objectivity relates to the possible effects that bias, conflict of interest, or the influence of others may have on the professional or business judgment of the auditor's expert. **A14**

Information regarding the competence, capabilities and objectivity of an auditor's expert may come from a variety of sources, such as: **A15**

- Personal experience with previous work of that expert.
- Discussions with that expert.
- Discussions with other auditors or others who are familiar with that expert's work.
- Knowledge of that expert's qualifications, membership of a professional body or industry association, license to practice, or other forms of external recognition.
- Published papers or books written by that expert.
- The auditor's firm's quality control policies and procedures (see paragraphs A11–A13).

Matters relevant to evaluating the competence, capabilities and objectivity of the auditor's expert include whether that expert's work is subject to technical performance standards or other professional or industry requirements, for example, ethical standards and other membership requirements of a professional body or industry association, accreditation standards of a licensing body, or requirements imposed by law or regulation. **A16**

Other matters that may be relevant include: **A17**

- The relevance of the auditor's expert's competence to the matter for which that expert's work will be used, including any areas of specialty within that expert's field. For example, a particular actuary may specialize in property and casualty insurance, but have limited expertise regarding pension calculations.
- The auditor's expert's competence with respect to relevant accounting and auditing requirements, for example, knowledge of assumptions and methods, including models where applicable, that are consistent with the applicable financial reporting framework.
- Whether unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures indicate that it may be necessary to reconsider the initial evaluation of the competence, capabilities and objectivity of the auditor's expert as the audit progresses.

**A18** A broad range of circumstances may threaten objectivity, for example, self-interest threats, advocacy threats, familiarity threats, self-review threats, and intimidation threats. Safeguards may eliminate or reduce such threats, and may be created by external structures (for example, the auditor's expert's profession, legislation or regulation), or by the auditor's expert's work environment (for example, quality control policies and procedures). There may also be safeguards specific to the audit engagement.

**A19** The evaluation of the significance of threats to objectivity and of whether there is a need for safeguards may depend upon the role of the auditor's expert and the significance of the expert's work in the context of the audit. There may be some circumstances in which safeguards cannot reduce threats to an acceptable level, for example, if a proposed auditor's expert is an individual who has played a significant role in preparing the information that is being audited, that is, if the auditor's expert is a management's expert.

**A20** When evaluating the objectivity of an auditor's external expert, it may be relevant to:

- (a) Inquire of the entity about any known interests or relationships that the entity has with the auditor's external expert that may affect that expert's objectivity.
- (b) Discuss with that expert any applicable safeguards, including any professional requirements that apply to that expert; and evaluate whether the safeguards are adequate to reduce threats to an acceptable level. Interests and relationships that it may be relevant to discuss with the auditor's expert include:
  - Financial interests.
  - Business and personal relationships.
  - Provision of other services by the expert, including by the organization in the case of an external expert that is an organization.

In some cases, it may also be appropriate for the auditor to obtain a written representation from the auditor's external expert about any interests or relationships with the entity of which that expert is aware.

*Confirmation of Independence of an Auditor's External Expert*  
(Ref: Para. 9R-1)

**0-1** For statutory audits of financial statements of public interest entities, ISA (UK) 260 (Revised June 2016)<sup>12a</sup> requires the auditor to communicate in the additional report to the audit committee when the auditor has used the work of an external expert and to confirm that the auditor obtained confirmation from the auditor's external expert regarding the external expert's independence.

*Obtaining an Understanding of the Field of Expertise of the Auditor's Expert*  
(Ref: Para. 10)

**A21** The auditor may obtain an understanding of the auditor's expert's field of expertise through the means described in paragraph A7, or through discussion with that expert.

<sup>12a</sup> ISA (UK) 260 (Revised June 2016), *Communication with Those Charged with Governance*, paragraph 16R-2(c).

Aspects of the auditor's expert's field relevant to the auditor's understanding may include: **A22**

- Whether that expert's field has areas of specialty within it that are relevant to the audit (see paragraph A17).
- Whether any professional or other standards, and regulatory or legal requirements apply.
- What assumptions and methods, including models where applicable, are used by the auditor's expert, and whether they are generally accepted within that expert's field and appropriate for financial reporting purposes.
- The nature of internal and external data or information the auditor's expert uses.

*Agreement with the Auditor's Expert*

(Ref: Para. 11)

The nature, scope and objectives of the auditor's expert's work may vary considerably with the circumstances, as may the respective roles and responsibilities of the auditor and the auditor's expert, and the nature, timing and extent of communication between the auditor and the auditor's expert. It is therefore required that these matters are agreed between the auditor and the auditor's expert regardless of whether the expert is an auditor's external expert or an auditor's internal expert. **A23**

The matters noted in paragraph 8 may affect the level of detail and formality of the agreement between the auditor and the auditor's expert, including whether it is appropriate that the agreement be in writing. For example, the following factors may suggest the need for a more detailed agreement than would otherwise be the case, or for the agreement to be set out in writing: **A24**

- The auditor's expert will have access to sensitive or confidential entity information.
- The respective roles or responsibilities of the auditor and the auditor's expert are different from those normally expected.
- Multi-jurisdictional legal or regulatory requirements apply.
- The matter to which the auditor's expert's work relates is highly complex.
- The auditor has not previously used work performed by that expert.
- The greater the extent of the auditor's expert's work, and its significance in the context of the audit.

The agreement between the auditor and an auditor's external expert is often in the form of an engagement letter. The Appendix lists matters that the auditor may consider for inclusion in such an engagement letter, or in any other form of agreement with an auditor's external expert. **A25**

When there is no written agreement between the auditor and the auditor's expert, evidence of the agreement may be included in, for example: **A26**

- Planning memoranda, or related working papers such as the audit program.
- The policies and procedures of the auditor's firm. In the case of an auditor's internal expert, the established policies and procedures to which that expert is subject may include particular policies and procedures in relation to that expert's work. The extent of documentation in the auditor's working papers depends on the nature of such policies and procedures. For example, no documentation may be required in the auditor's working papers if the

auditor's firm has detailed protocols covering the circumstances in which the work of such an expert is used.

#### *Nature, Scope and Objectives of Work*

(Ref: Para. 11(a))

- A27 It may often be relevant when agreeing on the nature, scope and objectives of the auditor's expert's work to include discussion of any relevant technical performance standards or other professional or industry requirements that the expert will follow.

#### *Respective Roles and Responsibilities*

(Ref: Para. 11(b))

- A28 Agreement on the respective roles and responsibilities of the auditor and the auditor's expert may include:
- Whether the auditor or the auditor's expert will perform detailed testing of source data.
  - Consent for the auditor to discuss the auditor's expert's findings or conclusions with the entity and others, and to include details of that expert's findings or conclusions in the basis for a modified opinion in the auditor's report, if necessary (see paragraph A42).
  - Any agreement to inform the auditor's expert of the auditor's conclusions concerning that expert's work.

#### *Working Papers*

- A29 Agreement on the respective roles and responsibilities of the auditor and the auditor's expert may also include agreement about access to, and retention of, each other's working papers. When the auditor's expert is a member of the engagement team, that expert's working papers form part of the audit documentation. Subject to any agreement to the contrary, auditor's external experts' working papers are their own and do not form part of the audit documentation.

#### *Communication*

(Ref: Para. 11(c))

- A30 Effective two-way communication facilitates the proper integration of the nature, timing and extent of the auditor's expert's procedures with other work on the audit, and appropriate modification of the auditor's expert's objectives during the course of the audit. For example, when the work of the auditor's expert relates to the auditor's conclusions regarding a significant risk, both a formal written report at the conclusion of that expert's work, and oral reports as the work progresses, may be appropriate. Identification of specific partners or staff who will liaise with the auditor's expert, and procedures for communication between that expert and the entity, assists timely and effective communication, particularly on larger engagements.

#### *Confidentiality*

(Ref: Para. 11(d))

- A31 It is necessary for the confidentiality provisions of relevant ethical requirements that apply to the auditor also to apply to the auditor's expert. Additional requirements may be imposed by law or regulation. The entity may also have requested that specific confidentiality provisions be agreed with auditor's external experts.

### *Evaluating the Adequacy of the Auditor's Expert's Work*

(Ref: Para. 12)

The auditor's evaluation of the auditor's expert's competence, capabilities and objectivity, the auditor's familiarity with the auditor's expert's field of expertise, and the nature of the work performed by the auditor's expert affect the nature, timing and extent of audit procedures to evaluate the adequacy of that expert's work for the auditor's purposes. A32

#### *The Findings and Conclusions of the Auditor's Expert*

(Ref: Para. 12(a))

Specific procedures to evaluate the adequacy of the auditor's expert's work for the auditor's purposes may include: A33

- Inquiries of the auditor's expert.
- Reviewing the auditor's expert's working papers and reports.
- Corroborative procedures, such as:
  - Observing the auditor's expert's work;
  - Examining published data, such as statistical reports from reputable, authoritative sources;
  - Confirming relevant matters with third parties;
  - Performing detailed analytical procedures; and
  - Reperforming calculations.
- Discussion with another expert with relevant expertise when, for example, the findings or conclusions of the auditor's expert are not consistent with other audit evidence.
- Discussing the auditor's expert's report with management.

Relevant factors when evaluating the relevance and reasonableness of the findings or conclusions of the auditor's expert, whether in a report or other form, may include whether they are: A34

- Presented in a manner that is consistent with any standards of the auditor's expert's profession or industry;
- Clearly expressed, including reference to the objectives agreed with the auditor, the scope of the work performed and standards applied;
- Based on an appropriate period and take into account subsequent events, where relevant;
- Subject to any reservation, limitation or restriction on use, and if so, whether this has implications for the auditor; and
- Based on appropriate consideration of errors or deviations encountered by the auditor's expert.

#### *Assumptions, Methods and Source Data*

##### *Assumptions and Methods*

(Ref: Para. 12(b))

When the auditor's expert's work is to evaluate underlying assumptions and methods, including models where applicable, used by management in developing A35

- (vi) The risk of loss resulting from inadequate or failed internal processes and systems, or from external events, including the risk of fraud from both internal and external sources;
- (vii) The risk that there is inadequate or non-timely maintenance of valuation techniques used to measure financial instruments; and
- (viii) Legal risk, which is a component of operational risk, and relates to losses resulting from a legal or regulatory action that invalidates or otherwise precludes performance by the end user or its counterparty under the terms of the contract or related netting arrangements. For example, legal risk could arise from insufficient or incorrect documentation for the contract, an inability to enforce a netting arrangement in bankruptcy, adverse changes in tax laws, or statutes that prohibit entities from investing in certain types of financial instruments.
- (e) Model risk, which is the risk that imperfections and subjectivity of valuation models used to determine the value of certain types of financial instrument are not properly understood and accounted for or adjusted for. This includes the risk that undue reliance is placed by staff on information derived from valuation models, in managing financial instrument positions, with the result that they overlook the fundamentals of risk management and control of market, counterparty and operational risk for these types of transactions.

19 Other considerations relevant to risks of using financial instruments include:

- The risk of fraud that may be increased if, for example, an employee in a position to perpetrate a financial fraud understands both the financial instruments and the processes for accounting for them, but management and those charged with governance have a lesser degree of understanding
- The risk that master netting arrangements<sup>8</sup> may not be properly reflected in the financial statements.
- The risk that some financial instruments may change between being assets or liabilities during their term and that such change may occur rapidly.

The potential for rapid changes in prices, coupled with the structure of certain financial instruments, also can affect credit risk exposure. For example, highly leveraged financial instruments or financial instruments with longer maturity can result in credit risk exposure increasing quickly after a transaction has been undertaken.

### Controls relating to financial instruments

- 20 The extent of an entity's use of financial instruments and the degree of complexity of the instruments are important determinants of the necessary level of sophistication of the entity's internal control. For example, smaller entities may use less structured products and simple processes and procedures to achieve their objectives.
- 21 Often, it is the role of those charged with governance to set the tone regarding, and approve and oversee the extent of use of, financial instruments while it is

<sup>8</sup> An entity that undertakes a number of financial instrument transactions with a single counterparty may enter into a master netting arrangement with that counterparty. Such an agreement provides for a single net settlement of all financial instruments covered by the agreement in the event of default of any one contract.

management's role to manage and monitor the entity's exposures to those risks. Management and, where appropriate, those charged with governance are also responsible for designing and implementing a system of internal control to enable the preparation of financial statements in accordance with the applicable financial reporting framework. An entity's internal control over financial instruments is more likely to be effective when management and those charged with governance have:

- (a) Established an appropriate control environment, active participation by those charged with governance in controlling the use of financial instruments, a logical organizational structure with clear assignment of authority and responsibility, and appropriate human resource policies and procedures. In particular, clear rules are needed on the extent to which those responsible for financial instrument activities are permitted to act. Such rules have regard to any legal or regulatory restrictions on using financial instruments. For example, certain public sector entities may not have the power to conduct business using derivatives;
- (b) Established a risk management process relative to the size of the entity and the complexity of its financial instruments (for example, in some entities a formal risk management function may exist);
- (c) Established information systems that provide those charged with governance with an understanding of the nature of the financial instrument activities and the associated risks, including adequate documentation of transactions;
- (d) Designed, implemented and documented a system of internal control to:
  - Provide reasonable assurance that the entity's use of financial instruments is within its risk management policies;
  - Properly present financial instruments in the financial statements;
  - Ensure that the entity is in compliance with applicable laws and regulations; and
  - Monitor risk.

The Appendix provides examples of controls that may exist in an entity that deals in a high volume of financial instrument transactions; and

- (e) Established appropriate accounting policies, including valuation policies, in accordance with the applicable financial reporting framework.

Key elements of risk management processes and internal control relating to an entity's financial instruments include:

- Setting an approach to define the amount of risk exposure that the entity is willing to accept when engaging in financial instrument transactions (this may be referred to as its "risk appetite"), including policies for investing in financial instruments, and the control framework in which the financial instrument activities are conducted;
- Establishing processes for the documentation and authorization of new types of financial instrument transactions which consider the accounting, regulatory, legal, financial and operational risks that are associated with such instruments;
- Processing financial instrument transactions, including confirmation and reconciliation of cash and asset holdings to external statements, and the payments process;

pricing the financial instrument may not represent fair value on the measurement date, and therefore may need to be adjusted separately to comply with the applicable financial reporting framework.

Adjustments are not appropriate if they adjust the measurement and valuation of the financial instrument away from fair value as defined by the applicable financial reporting framework, for example for conservatism.

#### *Observable and unobservable inputs*

- 38 As mentioned above, financial reporting frameworks often categorize inputs according to the degree of observability. As activity in a market for financial instruments declines and the observability of inputs declines, measurement uncertainty increases. The nature and reliability of information available to support valuation of financial instruments varies depending on the observability of inputs to its measurement, which is influenced by the nature of the market (for example, the level of market activity and whether it is through an exchange or over-the-counter (OTC)). Accordingly, there is a continuum of the nature and reliability of evidence used to support valuation, and it becomes more difficult for management to obtain information to support a valuation when markets become inactive and inputs become less observable.
- 39 When observable inputs are not available, an entity uses unobservable inputs (level 3 inputs) that reflect the assumption that market participants would use when pricing the financial asset or the financial liability, including assumptions about risk. Unobservable inputs are developed using the best information available in the circumstances. In developing unobservable inputs, an entity may begin with its own data, which is adjusted if reasonably available information indicates that (a) other market participants would use different data or (b) there is something particular to the entity that is not available to other market participants (for example, an entity-specific synergy).

#### *Effects of inactive markets*

- 40 Measurement uncertainty increases and valuation is more complicated when the markets in which financial instruments or their component parts are traded become inactive<sup>8a</sup>. There is no clear point at which an active market becomes inactive, though financial reporting frameworks may provide guidance on this issue. Characteristics of an inactive market include a significant decline in the volume and level of trading activity, available prices vary significantly over time or among market participants or the prices are not current. However, assessing whether a market is inactive requires judgment.
- 41 When markets are inactive, prices quoted may be stale (that is, out of date), may not represent prices at which market participants may trade or may represent forced transactions (such as when a seller is required to sell an asset to meet regulatory or legal requirements, needs to dispose of an asset immediately to create liquidity or the existence of a single potential buyer as a result of the legal or time restrictions imposed). Accordingly, valuations are developed based on level 2 and level 3 inputs. Under such circumstances, entities may have:

- Protocols for acquiring pricing indicators from as many different sources as possible;

<sup>8a</sup> Guidance for auditors on issues that may arise in adverse market conditions is provided in *Bulletins 2008/1 Audit Issues When Financial Market Conditions are Difficult and Credit Facilities may be Limited and 2008/10 Going Concern Issues During the Current Economic Conditions*.

- A valuation policy that includes a process for determining whether level 1 inputs are available;
- An understanding of how particular prices or inputs from external sources used as inputs to valuation techniques were calculated in order to assess their reliability. For example, in an active market, a broker quote on a financial instrument that has not traded is likely to reflect actual transactions on a similar financial instrument, but, as the market becomes less active, the broker quote may rely more on proprietary valuation techniques to determine prices;
- An understanding of how deteriorating business conditions affect the counterparty, as well as whether deteriorating business conditions in entities similar to the counterparty may indicate that the counterparty may not fulfill its obligations (that is, non-performance risk);
- Policies for adjusting for measurement uncertainties. Such adjustments can include model adjustments, lack of liquidity adjustments, credit risk adjustments, and other risk adjustments;
- The capability to calculate the range of realistic outcomes given the uncertainties involved, for example by performing a sensitivity analysis; and
- Policies for identifying when a fair value measurement input moves to a different level of the fair value hierarchy.

Particular difficulties may develop where there is severe curtailment or even cessation of trading in particular financial instruments. In these circumstances, financial instruments that have previously been valued using market prices may need to be valued using a model. 42

#### *Management's valuation process*

Techniques that management may use to value their financial instruments include observable prices, recent transactions, and models that use observable or unobservable inputs. Management may also make use of: 43

- A third-party pricing source, such as a pricing service or broker quote; or
- A valuation expert.

Third-party pricing sources and valuation experts may use one or more of these valuation techniques.

In many financial reporting frameworks, the best evidence of a financial instrument's fair value is found in contemporaneous transactions in an active market (that is, level 1 inputs). In such cases, the valuation of a financial instrument may be relatively simple. Quoted prices for financial instruments that are listed on exchanges or traded in liquid over-the-counter markets may be available from sources such as financial publications, the exchanges themselves or third-party pricing sources. When using quoted prices, it is important that management understand the basis on which the quote is given to ensure that the price reflects market conditions at the measurement date. Quoted prices obtained from publications or exchanges may provide sufficient evidence of fair value when, for example: 44

- The prices are not out of date or "stale" (for example, if the quote is based on the last traded price and the trade occurred some time ago); and
- The quotes are prices at which dealers would actually trade the financial instrument with sufficient frequency and volume.

- 51 The cash flows of an asset backed security may be affected by prepayments of the underlying collateral and by potential default risk and resulting estimated loss severities. Prepayment assumptions, if applicable, are generally based on evaluating market interest rates for similar collateral to the rates on the collateral underlying the security. For example, if market interest rates for mortgages have declined then the underlying mortgages in a security may experience higher prepayment rates than originally expected. Estimating potential default and loss severity involves close evaluation of the underlying collateral and borrowers to estimate default rates. For example, when the underlying collateral comprises residential mortgages, loss severities may be affected by estimates of residential housing prices over the term of the security.

#### Third-party pricing sources

- 52 Entities may use third-party pricing sources in order to obtain fair value information. The preparation of an entity's financial statements, including the valuation of financial instruments and the preparation of financial statement disclosures relating to these instruments, may require expertise that management does not possess. Entities may not be able to develop appropriate valuation techniques, including models that may be used in a valuation, and may use a third-party pricing source to arrive at a valuation or to provide disclosures for the financial statements. This may particularly be the case in smaller entities or in entities that do not engage in a high volume of financial instruments transactions (for example, non-financial institutions with treasury departments). Even though management has used a third-party pricing source, management is ultimately responsible for the valuation.
- 53 Third-party pricing sources may also be used because the volume of securities to price over a short timeframe may not be possible by the entity. This is often the case for traded investment funds that must determine a net asset value each day. In other cases, management may have their own pricing process but use third-party pricing sources to corroborate their own valuations.
- 54 For one or more of these reasons most entities use third-party pricing sources when valuing securities either as a primary source or as a source of corroboration for their own valuations. Third-party pricing sources generally fall into the following categories:
- Pricing services, including consensus pricing services; and
  - Brokers providing broker quotes.

#### Pricing services

- 55 Pricing services provide entities with prices and price-related data for a variety of financial instruments, often performing daily valuations of large numbers of financial instruments. These valuations may be made by collecting market data and prices from a wide variety of sources, including market makers, and, in certain instances, using internal valuations techniques to derive estimated fair values. Pricing services may combine a number of approaches to arrive at a price. Pricing services are often used as a source of prices based on level 2 inputs. Pricing services may have strong controls around how prices are developed and their customers often include a wide variety of parties, including buy and sell side investors, back and middle office functions, auditors and others.
- 56 Pricing services often have a formalized process for customers to challenge the prices received from the pricing services. These challenge processes usually

require the customer to provide evidence to support an alternative price, with challenges categorized based on the quality of evidence provided. For example, a challenge based on a recent sale of that instrument that the pricing service was not aware of may be upheld, whereas a challenge based on a customer's own valuation technique may be more heavily scrutinized. In this way, a pricing service with a large number of leading participants, both buy and sell side, may be able to constantly correct prices to more fully reflect the information available to market participants.

When considering whether a corrected price gives a suitable basis for valuation in the financial statements, consideration should be given to how long the challenge process has taken and whether the underlying data remains valid or there have been developments, such as market movements, to take account of.

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#### Consensus pricing services

Some entities may use pricing data from consensus pricing services which differ from other pricing services. Consensus pricing services obtain pricing information about an instrument from several participating entities (subscribers). Each subscriber submits prices to the pricing service. The pricing service treats this information confidentially and returns to each subscriber the consensus price, which is usually an arithmetical average of the data after a data cleansing routine has been employed to eliminate outliers. For some markets, such as for exotic derivatives, consensus prices might constitute the best available data. However, many factors are considered when assessing the representational faithfulness of the consensus prices including, for example:

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- Whether the prices submitted by the subscribers reflect actual transactions or just indicative prices based on their own valuation techniques.
- The number of sources from which prices have been obtained.
- The quality of the sources used by the consensus pricing service.
- Whether participants include leading market participants.
- Whether the market is one sided, where all the subscribers have positions in the same direction, causing the results to be skewed.

Typically consensus prices are only available to subscribers who have submitted their own prices to the service. Accordingly not all entities will have direct access to consensus prices. Because a subscriber generally cannot know how the prices submitted were estimated, other sources of evidence in addition to information from consensus pricing services may be needed for management to support their valuation. In particular, this may be the case if the sources are providing indicative prices based on their own valuation techniques and management is unable to obtain an understanding of how these sources calculated their prices.

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#### Brokers providing broker quotes

As brokers provide quotes only as an incidental service for their clients, quotes they provide differ in many respects from prices obtained in pricing services. Brokers may be unwilling to provide information about the process used to develop their quote, but may have access to information on transactions about which a pricing service may not be aware. Broker quotes may be executable or indicative. Indicative quotes are a broker's best estimate of fair value, whereas an executable quote shows that the broker is willing to transact at this price. Executable quotes are strong evidence of fair value. Indicative quotes are less

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so because of the lack of transparency into the methods used by the broker to establish the quote. In addition the rigor of controls over the brokers' quote often will differ depending on whether the broker also holds the same security in its own portfolio. Broker quotes are often used for securities with level 3 inputs and sometimes may be the only external information available.

- 59-1 Where brokers have not observed recent executed transactions the quality of their indicative quotations may be affected. If brokers do not hold positions the quality of their quotes will depend on their interactions with dealers in the specific market.

#### Further considerations relating to third-party pricing sources

- 60 Understanding how the pricing sources calculated a price enables management to determine whether such information is suitable for use in its valuation, including as an input to a valuation technique and in what level of inputs the security should be categorized for disclosure purposes. For example, third-party pricing sources may value financial instruments using proprietary models, and it is important that management understands the methodology, assumptions and data used.
- 61 If fair value measurements obtained from third-party pricing sources are not based on the current prices of an active market, it will be necessary for management to evaluate whether the fair value measurements were derived in a manner that is consistent with the applicable financial reporting framework. Management's understanding of the fair value measurement includes:
- How the fair value measurement was determined—for example, whether the fair value measurement was determined by a valuation technique, in order to assess whether it is consistent with the fair value measurement objective;
  - Whether the quotes are indicative prices, indicative spread, or binding offers; and
  - How frequently the fair value measurement is estimated by the third-party pricing sources—in order to assess whether it reflects market conditions at the measurement date.

Understanding the bases on which third-party pricing sources have determined their quotes in the context of the particular financial instruments held by the entity assists management in evaluating the relevance and reliability of this evidence to support its valuations.

- 62 It is possible that there will be disparities between price indicators from different sources. Understanding how the price indicators were derived, and investigating these disparities, assists management in corroborating the evidence used in developing its valuation of financial instruments in order to evaluate whether the valuation is reasonable. Simply taking the average of the quotes provided, without doing further research, may not be appropriate, because one price in the range may be the most representative of fair value and this may not be the average. To evaluate whether its valuations of financial instruments are reasonable, management may:

- Look at the performance of price providers in the past. For example it may be that a price provider consistently over or under prices a particular asset class and that this would reduce the reliance being placed on that provider;

- Consider whether actual transactions represent forced transactions rather than transactions between willing buyers and willing sellers. This may invalidate the price as a comparison;
- Analyze the expected future cash flows of the instrument. This could be performed as an indicator of the most relevant pricing data;
- Depending on the nature of what is unobservable, extrapolate from observed prices to unobserved ones (for example, there may be observed prices for maturities up to ten years but not longer, but the ten year price curve may be capable of being extrapolated beyond ten years as an indicator). Care is needed to ensure that extrapolation is not carried so far beyond the observable curve that its link to observable prices becomes too tenuous to be reliable;
- Compare prices within a portfolio of financial instruments to each other to make sure that they are consistent among similar financial instruments;
- Use more than one model to corroborate the results from each one, having regard to the data and assumptions used in each; or
- Evaluate movements in the prices for related hedging instruments and collateral.

In coming to its judgment as to its valuation, an entity may also consider other factors that may be specific to the entity's circumstances.

#### Independent Price Verification Function

A feature of some entities' internal control is an independent price verification (IPV) function. This department is responsible for separately verifying the price of some financial instruments and may use alternative data sources, methodologies and assumptions. The IPV function, while not independent of the entity, often provides an objective management challenge to the pricing that has been developed in another part of the entity and is therefore often a key control over management's valuation process. To verify the price of financial instruments independently of management this function may:

- Perform revaluation of the entity's financial instruments using independent inputs and assumptions, comparing these values to those developed in another part of the entity.
- Compare the inputs used to develop financial instrument valuations by another part of the entity to independently obtained inputs (parameter based IPV).
- Make recommendations to management around adjustments to books and records to align valuations developed in another part of the entity with fair value.
- Assess the sufficiency and appropriateness of the information used, including evaluating third party pricing services such as consensus pricing services and broker quotes.
- Calculate fair value adjustments or other adjustments required to account for residual uncertainties in the valuation process.

#### Use of valuation experts

Management may engage a valuation expert from an investment bank, broker, or other valuation firm to value some or all of its securities. Unlike pricing services

## Introduction

- 1 Stakeholder pension schemes can be set up by trustees (trust schemes) or can be established by managers (contract schemes). The Pensions Regulator has responsibility for maintaining the register of stakeholder pension schemes, and for the governance of schemes. Under the regulations The Pensions Regulator cannot register, and must de-register, stakeholder schemes if they fail to meet the conditions for being a stakeholder scheme set out in legislation. The Financial Services Authority (FSA) has responsibility for regulating the sales and marketing of stakeholder pensions, and is also responsible for authorising and supervising the firms acting as stakeholder managers as well as firms involved in managing the funds invested in stakeholder schemes.
- 2 This Bulletin has been issued by the FRC to provide guidance for reporting accountants in relation to the requirements placed upon them in connection with stakeholder pension schemes. It does not constitute guidance from The Pensions Regulator or the FSA.
- 3 The principal legislation regulating Stakeholder pensions is The Welfare Reform and Pensions Act 1999 ("the Act") and The Stakeholder Pension Schemes Regulations 2000<sup>1</sup> ("the Regulations"). The relevant parts of the Regulations came into force on 1 October 2000 but have been subject to subsequent amending regulations. This Bulletin reflects the version of the Regulations in force as at 5 April 2012.
- 4 Regulation 12(2)(a) requires the trustees or manager to make an annual declaration<sup>2</sup> containing various statements in accordance with Regulation 12(5). Regulation 12(5)(a) requires a statement that in the opinion of the trustees or manager there are systems and controls in place which provide reasonable assurance that:
  - (i) Regulations 13, 14 and 14B<sup>3</sup> of the regulations have been complied with in relation to the scheme;
  - (ii) transactions for the purposes of the scheme in securities, property or other assets have occurred at a fair market value;
  - (iii) the value of members' rights has been determined in accordance with the provisions in the instruments establishing the scheme; and
  - (iv) adequate records have been maintained for the purposes of providing to members the statement required by Regulation 18A(1)<sup>4</sup> of the regulations.
- 5 Regulation 12(5)(b) requires a statement describing the process that has been undertaken in order to arrive at the opinion expressed in the statement required by Regulation 12(5)(a).
- 6 Regulations 12(5)(c) and (d) require statements concerning compliance with the conditions in section 1(1) of the Act, and explaining the requirements of Regulations 13, 14, 14B and 18A(1).

<sup>1</sup> SI 2000 no.1403.

<sup>2</sup> Regulation 12 of The Stakeholder Pension Schemes Regulations 2000, as amended, is reproduced in full in Appendix 2 of this Bulletin.

<sup>3</sup> These regulations impose limits on the amount of charges and deductions which may be made by a stakeholder pension scheme and on the manner in which charges may be made by such a scheme.

<sup>4</sup> This regulation requires a stakeholder pension scheme to provide an annual benefit statement to each member.

Regulation 12(6) requires the trustees or manager to provide the reporting accountant with documentation to demonstrate that the process described in the statement in accordance with Regulation 12(5)(b) has taken place. 7

Regulation 12(2)(b) requires that the trustees or manager shall obtain from a reporting accountant<sup>5</sup> statements made in accordance with Regulation 12(7) that 8

- (i) the reporting accountant has been provided with documentation as required by Regulation 12(6); and
- (ii) nothing has come to the attention of the reporting accountant that is inconsistent with the statement made in accordance with Regulation 12(5)(b), or

so far as the reporting accountant is unable to provide such statements, an explanation as to why he or she is unable to do so. The reporting accountant is not required to report on the statements made by the trustees or manager in accordance with Regulations 12(5)(c) or (d).

The trustees or managers are required by the Regulations to annex the reporting accountant's report to their declaration, and shall make the whole document available to members and beneficiaries of the scheme on request. 9

It is a condition of a scheme being a stakeholder pension scheme that the requirements of the Regulations are complied with. 10

The declarations by the trustees or managers and the reporting accountant's reports are due 6 months after the end of the scheme accounting period. 11

## Trustees' or managers' declarations

As described above, the trustees or managers are required to make statements to the effect that systems and controls provide reasonable assurance that specified aspects of the Regulations have been complied with and to describe the process that has been undertaken to make such statements. Guidance for trustees and managers to assist them in fulfilling these responsibilities has been issued by the Pensions Research Accountants Group (PRAG)<sup>6</sup>. 12

## Reporting Accountant's procedures

Regulation 11 sets out the processes to be followed for the appointment and resignation of the reporting accountant. The Regulation requires, in particular, that the reporting accountant acknowledge in writing within one month its receipt of the notice of appointment, and confirm that it will notify the trustees or managers of any conflict of interest to which the reporting accountant is subject in relation to the scheme immediately the reporting accountant becomes aware of its existence. The reporting accountant is also required, on resignation, to serve on the trustees or managers a written notice containing a statement specifying any circumstances connected with the resignation which in its opinion significantly affects the 13

<sup>5</sup> Regulation 11 defines a reporting accountant as follows:

"A person is eligible for appointment as the reporting accountant if the person is eligible under section 1212 of the Companies Act 2006 for appointment as a company auditor"

<sup>6</sup> "Making the Annual Declaration – A Guide for Trustees and Managers of Stakeholder Pension Schemes". Copies of this guidance may be obtained from PRAG's website: [www.prag.org.uk](http://www.prag.org.uk).



- 20 The reporting accountant is not required to obtain evidence concerning the specific requirements underlying Regulation 12(5)(a) – for example that the value of members’ rights has been determined in accordance with the provisions establishing the scheme. However, if during its review of the trustees’ or managers’ documentation the reporting accountant identifies facts or circumstances which suggest that:
- the trustees or managers may not be justified in their belief that their systems and controls provide reasonable assurance to enable them to make the statement required by Regulation 12(5)(a), or
  - because of apparent breaches of the legislation or other matters, the proposed statement required by Regulation 12(5)(a) is not supportable,
- the reporting accountant discusses its concerns with the trustees or managers as soon as is practicable.
- 21 If as a result of the discussion the reporting accountant remains of the view that significant internal control weaknesses or other matters exist which, in its opinion, call into question the credibility of the statement made by the trustees or managers in accordance with Regulation 12(5)(a), they consider modifying the statement in their report in respect of these matters.
- 22 Under normal circumstances the reporting accountant modifies its report in respect of apparent undisclosed breaches of the legislation, referred to in Regulation 12(5)(a), of which the reporting accountant becomes aware. In deciding whether to modify its report in respect of such breaches, the reporting accountant considers their significance. The materiality of the breach in monetary terms may not be relevant to a consideration of its significance. However, where breaches have occurred which were identified by the scheme’s own control systems, which were not indicative of a systemic problem, and which were corrected subsequently such that there was no monetary impact on any member or beneficiary of the scheme, they are unlikely to be significant.

### Reporting Accountant’s reports

- 23 The reporting accountant’s report on a declaration normally includes the following matters:
- a title identifying the persons to whom the report is addressed (which will normally be the trustees or managers of the scheme);
  - an introductory paragraph identifying the Regulations which are covered by the report;
  - separate sections, appropriately headed, dealing with
    - respective responsibilities of the trustees or managers and the reporting accountants, and
    - the basis of the reporting accountant’s statement, including (where appropriate) a reference to compliance with the guidance in this Bulletin;
  - the reporting accountant’s statement on the matters required by the Regulations;
  - the signature of the reporting accountant; and
  - the date of the reporting accountant’s report.

Appendix 1 of this Bulletin sets out an illustrative example of a reporting accountant’s report on the declaration. This example wording may need to be tailored to reflect particular circumstances.

As indicated in paragraphs 19-22 above, the reporting accountant modifies the statement in its report if the reporting accountant: 24

- has not been provided with documentation to demonstrate that the trustees’ or managers’ description of the process made in accordance with Regulation 12(5)(a) has taken place, or
- is aware of matters that are inconsistent with the trustees’ or managers’ description of the process, made in accordance with Regulation 12(5)(b), or
- is aware of matters which call into question the credibility of the statement made by the trustees or managers in accordance with Regulation 12(5)(a). These matters are likely to be connected with significant internal control weaknesses, or with breaches of the legislation referred to in Regulation 12(5)(a).

### Reporting to the regulators

Section 70(1) of The Pensions Act 2004 imposes on “a person who is otherwise 25 involved in advising trustees or managers of an occupational or personal pension scheme in relation to the scheme” a requirement to report to The Pensions Regulator. The Pensions Regulator’s Regulatory Code of Practice 01 “Reporting breaches of the law” clarifies that a reporting accountant appointed to a stakeholder scheme is subject to this requirement.

The reporting requirement referred to in paragraph 25 will exist where the 26 reporting accountant has reasonable cause to believe that:

- a duty which is relevant to the administration of the scheme in question, and is imposed by or by virtue of an enactment or rule of law, has not been or is not being complied with; and
- the failure to comply is likely to be of material significance to The Pensions Regulator in the exercise of any of its functions<sup>8</sup>.

A reporting accountant of a contract scheme who is also the auditor of the 27 managing entity considers whether it has a duty to report matters of material significance, of which it becomes aware in its capacity as auditor of the managing entity, to the FSA<sup>9</sup> under the FSMA<sup>10</sup> 2000 (Communications by Auditors) Regulations 2001. This is because there may be situations where it is not clear whether information coming to the attention of the reporting accountant is received in that capacity or in its role as auditor. Appendix 2 to ISA (UK and Ireland) 250 Section B provides guidance as to how information obtained in non-audit work may be relevant to the auditor in the planning and conduct of the audit and the steps that need to be taken to ensure the communication of information that is relevant to the audit.

<sup>8</sup> Further guidance on reporting to The Pensions Regulator is set out in Practice Note 15 (Revised) – The audit of occupational schemes in the United Kingdom.

<sup>9</sup> Further guidance on reporting to the FSA is set out in Practice Note 20 (Revised) – The audit of insurers in the United Kingdom.

<sup>10</sup> The Financial Services and Markets Act.

- 5 More specifically, the Standard establishes requirements with respect to:
- The process for forming, and the expression of, reasonable assurance opinions;
  - The process for forming, and the expression of, limited assurance opinions;
  - The provision of reasonable assurance to the FCA with respect to a firm's proposed adoption of:
    - The alternative approach to client money segregation; and
    - A non-standard method of client money reconciliation<sup>1</sup>; and
  - CASS auditor confirmations in respect of non-statutory client money trusts.
- 6 This Standard is the material published by the Financial Reporting Council<sup>2</sup> referred to in SUP 3.10.5B G, that deals specifically with the client assets report which the auditor is required to submit to the FCA, to which the FCA would expect CASS auditors to have regard.
- 7 The Standard contains references to, and extracts from, certain legislation and the CASS, SUP and SYSC rules of the FCA. These references are not intended to provide CASS auditors with the requisite knowledge of that legislation or those Rules. CASS auditors should have the requisite knowledge of those FCA rules that are relevant to the engagement. Readers are cautioned that the legislation and FCA Rules may change subsequent to publication of this Standard such that the references may no longer be accurate. The latest version of extant FCA rules can be found on the FCA website at: <https://www.handbook.fca.org.uk/>.

#### *Effective Date*

- 8 This Standard is effective for reports to the FCA with respect to Client Assets for periods commencing on or after 1 January 2016. Earlier adoption is permitted.

#### *Objectives*

- 9 The key objectives of the CASS Assurance Standard are to:
- Improve the quality of CASS audits and other CASS assurance engagements;
  - Adequately support and challenge CASS auditors when undertaking CASS assurance engagements and, in particular, to define the nature and extent of the work effort required for both reasonable assurance and limited assurance CASS assurance engagements without undermining the importance of the CASS auditor's judgment;
  - Support the objectives of the FCA's Client Asset Regime regarding the effective safekeeping of client assets and client monies and in particular to guard against systemic failure of the CASS Regime;
  - Manage the expectations of:
    - The management of firms that hold client assets; and
    - Third party administrators

<sup>1</sup> In this Standard CASS auditor's reports on adoption of the alternative approach to client money segregation and the non-standard method of client money reconciliation are collectively referred to as "Special Reports".

<sup>2</sup> The SUP reference is to the Auditing Practices Board. This reference is outdated and should be to the Financial Reporting Council.

- when a CASS auditor is engaged to provide assurance to the FCA on client assets that they handle or account for;
- Support the effective training of CASS auditors by both the accounting bodies and other training organisations;
- Help to establish realistic expectations regarding the integrity of the UK Client Asset regime with the beneficial owners of client assets; and
- Underpin the effectiveness of the FRC's enforcement and disciplinary activities with respect to CASS assurance engagements.

#### *Definitions*

For the purposes of the Client Asset Assurance Standard the following terms have the meanings attributed below: 10

*Applicable criteria:* The CASS rules and other applicable rules used, in the context of the particular CASS assurance engagement, to evaluate the status of a firm, in terms specified by the FCA, in connection with subject matter relating to the holding of client assets. Related assertions are the conditions that need to be met, as expressed or implied by the applicable criteria, if the firm's status could be described in the terms specified by the FCA.

*Breaches schedule:* Part 2 of the Client Assets Report: A Breaches Schedule identifying each CASS rule in respect of which a breach has been identified in the course of the CASS assurance engagement for the period covered by the Client Assets Report, whether identified by the CASS auditor or disclosed to it by the firm, or by any third party.

*CASS:* The Client Assets Sourcebook of the FCA.

*CASS assurance engagement:* An engagement in which a CASS auditor expresses an opinion designed to enhance the degree of confidence of the FCA concerning the status of a firm, in terms specified by the FCA, in connection with subject matter relating to the holding of client assets. CASS assurance engagements include CASS audits and certain other engagements to provide assurance to the FCA with respect to special reports or nonstatutory client money trusts.

*CASS assurance engagement risk:* The risk that the CASS auditor expresses an inappropriate opinion when the subject matter information is materially misstated.

*CASS audit:* A client asset assurance engagement that involves providing a Client Assets Report to the FCA.

*CASS auditor:* The person or persons conducting the CASS audit or other CASS assurance engagement, usually the CASS engagement leader or other members of the engagement team, or, as applicable, the auditing firm. Where a requirement expressly intends that it be fulfilled by the CASS engagement leader the term "CASS engagement leader" rather than "CASS auditor" is used. (N.B. A CASS auditor need not be the firm's statutory auditor).

*CASS auditor's report:* The report of the CASS auditor as required in the context of the CASS assurance engagement – in the case of a CASS audit, the Client Assets Report.

*CASS engagement leader:* The individual charged by the CASS auditor to be responsible for signing the CASS auditor's report.

**CASS engagement team:** *All partners and staff performing the CASS assurance engagement, and any individuals engaged by the auditing firm who perform procedures on the engagement. This excludes any external experts engaged by the auditing firm.*

**CASS records:** *The records of accounting entries and other records, both manual and electronic, that comprise or support the information system that accounts for the receipt, segregation, custody, monitoring, reconciliation, transfer and return of client assets, and for the safeguarding of clients' rights relating to such assets while they are held by the firm, in accordance with the CASS rules and other applicable rules.*

**CASS rules:** *The rules set out in CASS as denoted by the suffix R.*

**Client assets:** *Generic term encompassing client money, safe custody assets, and mandates and collateral, if applicable.*

**Client Assets Report:** *The assurance report that the CASS auditor is required to submit to the FCA either to provide reasonable assurance as to whether a firm's systems are adequate to enable it to comply throughout the period, and as to whether it was in compliance at the end of the period, with the CASS rules or to provide limited assurance that the firm did not hold client assets during the period. For insurance intermediaries, the FCA's rules require the report to be submitted to "the firm".*

**CMAR:** *The Client Money and Asset Return.*

**Control risk:** *The risk that a breach of the CASS rules that could be significant in the context of the applicable criteria and related assertions will not be prevented, or detected and corrected, on a timely basis by related internal controls.*

**Credit risk:** *The risk that a borrower will default on a debt by failing to make required payments.*

**Detection risk:** *The risk that the CASS auditor will not detect, as applicable in the context of the CASS assurance engagement, a deficiency in the design, implementation or operation of the firm's systems that are intended to enable it to comply with the relevant CASS rules, or a breach of the CASS rules that would be significant in the context of its reporting responsibilities.*

**Engagement quality control review:** *A process designed to provide an objective evaluation, on or before the date of the report, of the significant judgments the CASS engagement team made and the conclusions it reached in formulating the CASS auditor's report.*

**Engagement quality control reviewer:** *A partner, other person in the accounting firm, suitably qualified external person, or a team made up of such individuals, none of whom is part of the engagement team, with sufficient and appropriate experience and authority to objectively evaluate the significant judgments the CASS engagement team made and the conclusions it reached in formulating the CASS auditor's report.*

**Evaluation risk:** *The risk that the CASS auditor will fail to evaluate accurately the underlying subject matter against the applicable criteria and related assertions, in the terms specified by the FCA concerning the firm's status relating to the holding of client assets.*

**FCA:** *Financial Conduct Authority.*

**Firm:** *The regulated legal entity in respect of which the CASS auditor is reporting.*

**FSMA 2000:** *The Financial Services and Markets Act 2000*

**Hybrid opinions:** *Hybrid opinions are opinions that provide reasonable assurance with respect to one aspect of a firm's status relating to the holding of client assets and limited assurance with respect to another. For example, reasonable assurance may be provided with respect to the firm's compliance with the client money rules and limited assurance with respect to the custody asset rules because the firm's permissions do not allow it to hold custody assets.*

**Inherent risk:** *The risk of the management of the firm not preventing non-compliance with the CASS rules and other applicable rules due to the underlying susceptibility of the behaviour of the regulated firm to non-compliance with all of the applicable criteria and related assertions under those rules, before the application of internal controls.*

**Limited assurance Client Assets Report:** *A Client Assets Report providing a level of assurance where the engagement risk is reduced to a level that is acceptable in the circumstances of the engagement, but which is obtained when that risk is greater than the level of assurance that would be provided in a reasonable assurance Client Assets Report, as the basis for a negative form of expression of the CASS auditor's conclusion.*

**Nominee Company:** *A subsidiary of a firm in whose name custody assets of the firm are registered during the period.*

**Practitioner:** *A professional accountant in public practice.*

**Reasonable assurance Client Assets Report:** *A Client Assets Report providing a high but not absolute level of assurance, which is obtained when the CASS auditor has obtained sufficient appropriate assurance evidence to reduce assurance engagement risk to an acceptably low level in the circumstances of the engagement as the basis for a positive form of expression of the CASS auditor's conclusion.*

**Re-performance:** *The CASS auditor's independent execution of procedures or controls that were originally performed as part of the firm's internal controls.*

**Reportable breach:** *A breach of the FCA's rules of which the CASS auditor becomes aware which it reasonably believes may be of material significance to the FCA (see para 59).*

**Significant deficiency in internal control:** *A deficiency or combination of deficiencies in internal control relating to a firm's compliance with the CASS rules or other applicable rules that, in the auditor's professional judgment, is of sufficient importance to require the attention of those charged with governance.*

**Special Reports:** *The reports prepared by an independent auditor, subject to the provision of which, the FCA permits certain firms to use the "alternative approach" to client money segregation and a "non-standard method" of client money reconciliation under the CASS rules. In this Standard, both are referred to as "Special Reports".*

**Subject matter information:** *The outcome of the evaluation by the CASS auditor of the underlying subject matter against the applicable criteria and related assertions, in the terms specified by the FCA concerning the firm's status relating to the holding of client assets.*

**Those charged with governance:** *The person(s) or organisation(s) (for example a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the firm. This includes*

those provided for either in the FCA's template, or the wording in the illustrative example reports set out in Appendices 2 to 8 of this Standard shall only be used with the prior agreement of the FCA. The latest version of extant FCA rules can be found on the FCA website at: <https://www.handbook.fca.org.uk/>.

- 29 SUP 3.10 sets out the FCA's rules and guidance with respect to the duties of CASS auditors to report on client assets. Amongst other things SUP 3.10 establishes rules relating to:
- The period that a Client Assets Report may cover.
  - The time period allowed for the Client Assets Report to be delivered to the FCA and the firm.
  - The signing of the Client Assets Report.
  - Delivering a draft of the report to the firm.
- 30 The CASS auditor is required by SUP 3.10.8D R to deliver a draft of its Client Assets Report to the firm such that the firm has an adequate period of time (see paragraph 32) to consider its findings and provide the CASS auditor with comments explaining:
- (a) The circumstances that gave rise to each of the breaches identified in the draft Client Assets Report; and
  - (b) Any remedial actions that it has undertaken or plans to undertake to correct those breaches.
- 31 Such comments are required to be submitted to the CASS auditor on a timely basis i.e. before the CASS auditor is required to deliver its report to the FCA or to the firm. The comments are recorded by the CASS auditor in Column E of the Breaches Schedule.
- 32 In order to facilitate the processes outlined in the two preceding paragraphs the CASS auditor shall agree with the firm what constitutes "an adequate period of time" and record the agreement with the firm.

#### *Quality Control*

- 33 The CASS auditor shall comply with the applicable standards and guidance set out in International Standard on Quality Control (UK and Ireland) 1, and the CASS engagement leader shall have sufficient competence in the provision of assurance on client assets to accept responsibility for the assurance opinions in respect of the Client Assets Report.
- 34 The CASS engagement leader shall be satisfied that the assigned CASS engagement team collectively has the appropriate competence and capabilities to perform the engagement in accordance with this Standard and applicable legal and regulatory requirements.
- 35 The CASS engagement leader shall be satisfied that it will be able to evaluate the objectivity and competence of any other practitioner, not part of the engagement team, where the assurance work of that practitioner is to be used, to an extent that is sufficient to accept responsibility for the CASS auditor's report.

#### *Training*

The CASS engagement leader shall be satisfied that the CASS engagement team includes staff with experience in client asset work who, to the extent relevant to a particular engagement, have received training relevant to the circumstances of that engagement, for example in the following:

- The FCA's CASS Rules and applicable SUP<sup>6</sup> rules, in particular what constitutes a breach of the CASS Rules and the implications of the situations where the CASS rules require the CASS auditor to provide a Special Report to the firm.
- A firm's business model, such that reasonable expectations can be established throughout the CASS audit team as to the nature of client assets that the firm is likely to have (see paragraph 11).
- Assessing the design effectiveness of systems of internal control over client assets and evaluating whether the systems of internal control were in effect throughout the period and operating effectively.
- Practical challenges associated with the performance and review of client asset reconciliations.
- How the CASS rules seek to effectively segregate client assets within the context of applicable trust and insolvency law.  
(See paragraphs 56 to 58 of the Contextual Material).

#### *Responsibilities of the CASS engagement leader*

The CASS engagement leader shall, within the context of his or her firm's quality control standards for assurance engagements, take responsibility for the overall quality of the engagement. This includes responsibility for:

- (a) Appropriate acceptance and continuance procedures being performed;
- (b) The engagement being planned and performed (including appropriate direction and supervision) to comply with this and other applicable professional standards and applicable legal and regulatory requirements;
- (c) Assessing whether the engagement team and any other practitioners they intend to consult have sufficient knowledge of the specific aspects of the industry within which the firm operates and its corresponding products;
- (d) Appropriate documentation of the work performed on the engagement being maintained to provide evidence of the achievement of the CASS auditor's objectives and that the engagement was performed in accordance with this Standard and applicable legal and regulatory requirements;
- (e) Appropriate reviews of the work performed on the engagement, including reviewing the engagement documentation, before the date of the Client Assets Report; and
- (f) Appropriate consultation being undertaken by the engagement team on difficult or contentious matters.

<sup>6</sup> At the time of writing SUP 3 is the applicable SUP Rule.

- 52 **The date of the written representations shall be as near as practicable to, but not subsequent to, the date of the Client Assets Report.**
- 53 Representations from appropriate officials of the firm cannot replace other evidence the CASS auditor could reasonably expect to be available. Although written representations may provide necessary evidence, they do not provide sufficient appropriate evidence on their own about any of the matters with which they deal. Furthermore, the fact that the CASS auditor has received reliable written representations does not affect the nature or extent of other evidence that the CASS auditor should obtain.

### *Planning and Performing the Engagement*

#### *Planning*

- 54 **The CASS auditor shall plan the engagement so that it will be performed in an effective manner, including setting the scope, timing and direction of the engagement, and determining the nature, timing and extent of those risk assessment and other planned procedures that are required to be carried out in order to achieve the objective of the CASS auditor.**

#### *Understanding the Underlying Subject Matter and Other Engagement Circumstances*

- 55 **The CASS engagement leader and senior members of the CASS engagement team shall meet to discuss the susceptibility of the firm's client asset systems to breaches of the CASS Rules. Such discussions shall include among other things:**
- The firm's business model and changes in the model from the preceding year.**
  - New products and services introduced during the period.**
  - Changes made to IT and other reporting systems during the period.**
  - Developments in relevant laws and regulations which may impact on the assurance procedures to be undertaken.**
  - Waivers and modifications of CASS rules received by the firm during the year and any individual guidance received from the FCA.**
  - The implications of arrangements for third party administration of client assets.**
- 56 **Relevant matters shall also be communicated to members of the engagement team not involved in the meeting.**
- 57 **The CASS auditor shall enquire as to whether the firm has an internal audit function, or a separate compliance function, that is required to review the firm's compliance with the CASS Rules. If so, the CASS auditor shall obtain an understanding of its activities with respect to Client Assets and consider the findings of the internal audit function and/or the compliance function. Findings of an internal audit or compliance function in respect of breaches of the CASS rules will inform the CASS auditor's risk assessment.**

#### *The CASS auditor's duty to report to the FCA*

- 58 **Under the Financial Services and Markets Act 2000 (FSMA 2000) (Communications by Auditors) Regulations 2001 CASS auditors have duties in**

certain circumstances to make reports to the FCA. A CASS auditor has a duty to report breaches of the FCA's Rules of which it becomes aware which it reasonably believes may be of material significance to the FCA. If a CASS auditor becomes aware of such breaches, it does not wait to report them to the FCA by means of the Breaches Schedule that it appends to its routine assurance reports to the FCA. Appendix 12 sets out guidance for CASS auditors with respect to the duty to report to the FCA.

**Where a CASS auditor identifies a breach (that it reasonably believes may exist) is of material significance to the FCA and, therefore, reportable, it shall carry out such additional procedures as it considers necessary, to determine whether the facts and circumstances causes it reasonably to believe that the matter does in fact exist.** 59

**Where the CASS auditor has reason to believe that a matter (such as a breach of the CASS rules) does exist it shall obtain such evidence as is available to assess its implications for the CASS auditor's reporting responsibilities.** 60

A matter or group of matters is likely to be of material significance to the FCA when, due either to its nature or its potential financial impact, it is likely of itself to require investigation by the FCA. 61

**The CASS auditor shall report those matters that it believes to be of material significance to the FCA as soon as practicable.** 62

**The CASS auditor shall document:** 63

- The facts and circumstances that caused it to believe that the circumstances (such as a breach of the CASS rules) giving rise to the matters existed; and**
- The basis for its conclusions as to whether the matters are, or are likely to be, of material significance to the FCA.**

**The documentation shall clearly demonstrate the CASS auditor's reasoning for its decision (as the case may be) to report, or not to report, the matter to the FCA.**

#### *The CASS auditor's right to report to the FCA*

Section 342 of FSMA 2000 provides that no duty to which an auditor (including CASS auditors) of an authorised person (e.g. a firm) is subject shall be contravened by communicating in good faith to the FCA information or an opinion on a matter that the auditor reasonably believes is relevant to any functions of the FCA. 64

The scope of the duty to report can be quite wide particularly since, under the FCA's Principle for Businesses 11, a firm must disclose to the FCA anything related to the firm of which the FCA would reasonably expect notice. However, in circumstances where the CASS auditor concludes that a matter does not give rise to a statutory duty to report but nevertheless should be brought to the attention of the FCA, in the first instance the CASS auditor advises the directors, or equivalent, of the firm of its opinion. Where the CASS auditor is unable to obtain, within a reasonable period of time, adequate evidence that the directors, or equivalent, have properly informed the FCA of the matter, then the CASS auditor makes a report to the regulator without undue delay. 65

The CASS auditor may wish to take legal advice before deciding whether, and in what form, to exercise its right to make a report directly to the FCA in order to ensure, for example, that only relevant information is disclosed and that the form 66

and content of its report is such as to secure the protection of FSMA 2000. However, the CASS auditor recognises that obtaining legal advice may take time and that speed of reporting is likely to be important in order to protect the interests of customers and/or to enable the FCA to meet its statutory objectives.

### **Requirements Applicable to the Expression of Reasonable Assurance Opinions in a CASS Auditor's Report**

*The requirements and guidance in paragraphs 11 to 66 also apply to the expression of reasonable assurance opinions*

- 67 An overview of the process to form the opinion as to whether the firm has maintained systems adequate to enable it to comply with the relevant CASS rules for the period and that it was in compliance with the rules at the end of the period, along with the relevant considerations relating to various stages in the process, is depicted in the diagram in Appendix 1.
- 68 The nature and extent of the CASS auditor's work will be a matter of professional judgment based, among other things, on its assessment of "assurance engagement risk". That is the risk that the CASS auditor expresses an unmodified opinion that the firm has maintained systems adequate to enable it to comply with the relevant CASS rules during the period or that it was in compliance with the relevant rules at the end of the period, when reporting to the FCA, in circumstances where such opinions are not correct.
- 69 Assurance engagement risk with respect to engagements to express a reasonable assurance opinion with respect to Client Assets can be represented by the following components:
- Inherent risk: the risk of the management of the firm not preventing non-compliance with the CASS rules and other relevant FCA rules that are applicable to the firm due to the underlying susceptibility of the behaviour of the regulated firm to non-compliance with all of the assertions and related criteria under the applicable rules before the application of internal controls;
  - Control risk: the risk that a breach of the CASS rules that could be significant in the context of the assertions (see paragraph 70) will not be prevented, or detected and corrected, on a timely basis by related internal controls;
  - Detection risk: the risk that the CASS auditor will not detect a significant breach of the CASS Rules and will, therefore, fail to report the breach to the FCA; and
  - Evaluation risk: the risk that the CASS auditor will fail to measure or evaluate accurately, the underlying subject matter against the criteria.
- 70 The assertions and the related criteria that are applicable to the engagement may comprise a combination of:
- Applicable provisions of the CASS rules;
  - Waivers and Modifications granted to the firm by the FCA; and
  - Individual guidance from the FCA to a firm.
- 71 In overview, building on the understanding of the firm's business model, in order to assess assurance engagement risk with respect to each of the above components the CASS auditor:

- Establishes those FCA rules (especially the CASS rules) which are relevant to the firm's circumstances, systems and procedures;
- Establishes any other applicable criteria;
- In respect of each relevant rule and other criterion, establishes what the objectives of the firm's related controls should be (control objectives) in order to ensure compliance by the firm with the relevant rule, waiver, modification or guidance;
- Carries out a risk assessment and establishes appropriate quality control to address detection and evaluation risk; and
- Determines the nature and extent of assurance procedures that will provide sufficient appropriate assurance evidence that the firm has met the relevant control objectives for the assertions and criteria.

### *Assessing CASS Assurance Engagement Risk*

#### *Inherent risk and control risk*

To assess the risk of a firm failing to comply with the CASS rules, the CASS auditor shall obtain an understanding of the firm's organisational structure, operating environment, classes of transactions to which the CASS rules apply, cash flows and other engagement circumstances sufficient to:

- Enable the CASS auditor to identify and assess the risk of inappropriately expressing an unmodified opinion that the firm has maintained systems adequate to enable it to comply with the CASS Rules throughout the period;
- Enable the CASS auditor to identify and assess the risk of inappropriately expressing an unmodified opinion that the firm was in compliance with the CASS Rules at the end of the period; and
- Thereby, provide a basis for designing and performing procedures to respond to the assessed risks and to obtain reasonable assurance to support the CASS auditor's opinion.

The CASS auditor shall discuss with management the operation of the business, seek to understand what the firm has done to mitigate risk, and read relevant management information, for example:

- Operations Manuals.
- The firm's documentation of systems and controls.

In assessing the risk that the control environment may not be sufficient to prevent or detect a significant breach of the rules, the CASS auditor shall meet with senior management, the CASS Compliance Officer and, where applicable, the CF10a to confirm their understanding of the control environment, gained as set out in paragraph 73. The CASS auditor shall also consider other sources of information, for example:

- Compliance monitoring and internal audit programmes and results.
- Records maintained by the firm of any rule breaches and notifications to the FCA that may have occurred during the period.
- CMAR submissions made by the firm.
- The results of recent inspection visits made by the FCA.

(c) Assessing the likelihood of their occurrence; and

(d) Determining actions to address those risks.

- 86 If the CASS auditor identifies a risk that management has failed to identify, the auditor shall obtain an understanding of why management's process failed to identify it and determine if there is a significant deficiency in internal control with regard to the firm's risk assessment process.

*Monitoring activities*

- 87 The CASS auditor shall obtain an understanding of the major activities that the firm uses to monitor<sup>7</sup> internal control relevant to its compliance with the CASS rules and how the firm initiates remedial actions in response to deficiencies in its controls. Where the firm has an internal audit or compliance function, which covers those major activities intended to deliver compliance with the CASS rules, the CASS auditor shall perform or obtain, as appropriate, and document:

- an evaluation of whether the function's organisational status and relevant policies and procedures adequately support the objectivity of the internal auditors, or compliance function;
- an understanding of the nature of the internal audit or compliance function's responsibilities with respect to client assets;
- an assessment of whether the function applies a systematic and disciplined approach, including quality control; and
- the activities the function has performed or intends to perform with respect to client assets.

- 88 As the CASS auditor has sole responsibility for the CASS audit opinion, the use of internal auditors to provide direct assistance to a CASS auditor is prohibited in a CASS audit performed in accordance with this Standard. In addition, the CASS auditor's responsibility cannot be reduced by the CASS auditor using the work of the internal audit or compliance function. However, the CASS auditor is likely to find the work and findings of the internal audit or compliance function to be useful in making its risk assessment. The CASS auditor shall document its conclusion and the basis for this conclusion on how the work and findings of the internal audit or compliance function have impacted on the risk assessment.

- 89 The CASS auditor shall obtain an understanding of the sources of the information used in the firm's monitoring activities, and the basis upon which management considers the information to be sufficiently reliable for the purpose.

- 90 Much of the information used in monitoring may be produced by the firm's information system. If management assumes that data used for monitoring are accurate without having a basis for that assumption, errors that may exist in the information could potentially lead management to incorrect conclusions from its monitoring activities.

<sup>7</sup> *Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It includes assessing the design and operation of controls on a timely basis and taking necessary corrective actions modified for changes in conditions.*

*Evaluating the design of control activities*

The CASS auditor shall consider how the design of control activities: 91

- (a) Enables the firm to identify where client assets may arise in the business;
- (b) Seeks to ensure that client assets are segregated and safeguarded effectively;
- (c) Addresses the performance of internal and external reconciliations<sup>8</sup> as required by the CASS rules; and
- (d) Addresses the establishment and acknowledgement of trust status over client assets.

In the context of the CASS auditor's consideration required by paragraph 91, the CASS auditor shall evaluate: 92

- (a) Whether the system design identifies appropriate control activities in respect of those CASS rules that are applicable to the firm;
- (b) Whether those control activities are likely to provide reasonable assurance of compliance with the relevant CASS rules;
- (c) The implications of different controls for different parts of the business; and
- (d) Where appropriate, whether detective controls will be effective within the time periods (if any) permitted by the CASS Rules.

The CASS auditor shall further evaluate: 93

- (a) Whether there is adequate segregation of duties; and
- (b) Whether the design of the system incorporates sufficiently robust controls over system changes.

*Obtaining evidence to support the opinion as to whether the firm has maintained systems over client assets adequate to enable it to comply with the relevant CASS rules during the period.*

*Evaluating whether internal control activities were put into place as designed and whether their operation was effective*

The CASS auditor shall evaluate whether internal control activities were put into place to cover all client assets and whether they were designed effectively. Based on the conclusions reached, the CASS auditor shall adopt a suitable approach to test the effectiveness of the operation of these controls during the period. The CASS auditor's procedures to evaluate whether control activities were put into place as designed shall include walk-through tests of internal control activities. Based on these evaluations, the CASS auditor shall adopt a suitable approach to test the effectiveness of operation of these controls during the period. 94

The nature and extent of the auditor's evaluation will be a function of the results of its risk assessment and conclusions regarding the design effectiveness of the internal controls. In addition to the performance of walk-through tests, relevant procedures the CASS auditor considers performing include: 95

<sup>8</sup> *Or bank reconciliations for insurance intermediaries.*

- (a) Making enquiries of personnel at the firm, for example the CF10a.
  - (b) Observing the application of controls.
  - (c) Inspecting documents and reports, for example computer-generated error reports, client agreements, acknowledgement letters and custody agreements.
  - (d) Testing internal and external reconciliations.
- 96 The CASS auditor is required to report on the adequacy of the systems throughout the period under review. This requirement does not mean that the CASS auditor has to perform tests continuously throughout the period, but bases the extent and nature of its procedures to test the effectiveness of operation of control activities on its:
- (a) risk assessment, including its evaluation of the control environment; and
  - (b) evaluation of the design of the system of internal control.
- Selecting items for testing to obtain evidence of operation of controls*
- 97 **When designing tests of controls the CASS auditor shall determine the means of selecting items for testing that are effective in meeting the purpose of the assurance procedure.**
- 98 The means available to the CASS auditor for selecting items for testing are:
- (a) Selecting all items (This is likely to be appropriate only when there is a small number of items);
  - (b) Selecting specific items; and
  - (c) Sampling.
- 99 **When evaluating the effectiveness of the operation of controls, the auditor shall evaluate whether breaches that have been identified indicate that controls are or were not operating effectively.**
- 100 A breach may indicate the existence of a significant deficiency in internal control. The concept of effectiveness of the operation of controls recognises that some deviations in the way controls are applied by the firm may occur. Deviations from prescribed controls may be caused by such factors as changes in key personnel, fluctuations in volume of transactions and human error. The detected rate of deviation may indicate that the control cannot be relied on to sufficiently reduce the risk of breaches of the CASS rules.
- 101 A firm's systems and controls over client assets may be quite different to the systems and controls that it has over its own assets. It would be inappropriate to draw conclusions about the design and operating effectiveness of internal controls over client assets based on evaluations of the firm's systems and controls over its own assets.
- 102 The CASS rules require such records of client money and custody assets to be kept as are necessary to enable the firm "at any time and without delay" to distinguish client assets held for one client from client assets held for any other client and from its own assets. CASS auditors need to be aware of the risk that firms may have different systems in place at different times of the day (for example overnight deposit arrangements) or that a firm may have transferred client assets to another legal entity. The scope of their testing should address all the systems that may be applicable to client assets at all times.

*Use of Third Party Administrators*

When a firm enters into an arrangement with a Third Party Administrator (TPA) to outsource the operation of certain functions, such as fund administration, that are relevant to the firm's compliance with CASS rules, whether the firm retains full regulatory responsibility for compliance with CASS rules depends on the nature of the arrangements entered into between the firm, the TPA and the firm's clients. The firm retains full regulatory responsibility where the TPA simply owes contractual obligations to the firm to perform certain specified services and the TPA does not have a direct contractual relationship with the firm's clients.

An example of an arrangement where the firm retains full regulatory responsibility is an agreement entered into by a stockbroker to outsource clearing and settlement activities to another firm, without any change in the firm's arrangements with its clients. As settlement agent, the other firm undertakes an administrative role in the settlement of trades under a service level agreement. However, the stockbroker remains responsible for compliance with the relevant FCA rules, including CASS. In this type of arrangement, the outsourced functions support the firm's compliance with CASS. Such an arrangement is described as a "Model A Arrangement" in some parts of the stockbroking industry. Another common example of such an arrangement is where a fund management firm outsources certain functions related to fund administration to a TPA (which may or may not be an authorised firm) without any change in the firm's arrangements with its clients.

Alternatively, the firm and its TPA may agree to an arrangement in which the TPA takes direct responsibility for compliance with some or all of the provisions in CASS, which is referred to in some parts of the stockbroking industry as a "Model B Arrangement". For example, Model B is where a second firm takes responsibility for the stockbrokers' clearing and settlement activities, often called "give up broking". In such a scenario, the second firm is responsible for compliance with the FCA's rules (including the CASS Rules) insofar as they apply to clearing and settlement processes that are the subject of the arrangement.

The TPA can only assume such responsibility, if it is authorised by the FCA to conduct investment business and has the requisite permission from the FCA to hold or control the client money and/or custody assets in question. Such a transfer of responsibility only occurs if the firm's clients enter into terms of business with the TPA to establish that the TPA will be directly responsible to the client under CASS for protecting the clients' money or assets. In order to do so, the firm, the TPA and the client may enter into a tri-partite agreement that reflects the terms of business between both firms and the client. Alternatively, the firm and the TPA may each enter into separate agreements with the client to achieve this.

Although Model A and Model B arrangements may each be described as involving TPAs, the regulatory obligations of the firm and the TPA are different under each model and so, their impact on the scope of a CASS auditor's procedures is quite different. The actual arrangements entered into by firms can be extremely complex and members of a CASS engagement team need to have a thorough understanding both of the arrangements with the TPA and the firm's clients and of the firm's business model, particularly of the cash and other asset inflows and outflows as they apply both to the firm and to the TPA. This understanding provides a basis for establishing the respective regulatory responsibilities of the firm and (if any) the TPA for client assets and, therefore, expectations about the existence or otherwise of client assets in the context of the engagement.

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