

10/20**

Financial Services Authority

Improving the auditor's report on client assets

September 2010

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The Financial Services Authority invites comments on this Consultation Paper. Comments should reach us by 31 December 2010.

Comments may be sent by electronic submission using the form on the FSA's website at:

(www.fsa.gov.uk/Pages/Library/Policy/CP/2010/cp10_20_response.shtml).

Alternatively, please send comments in writing to:

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It is the FSA's policy to make all responses to formal consultation available for public inspection unless the respondent requests otherwise. A standard confidentiality statement in an e-mail message will not be regarded as a request for non-disclosure.

A confidential response may be requested from us under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Tribunal.

Copies of this Consultation Paper are available to download from our website – www.fsa.gov.uk. Alternatively, paper copies can be obtained by calling the FSA order line: 0845 608 2372.

List of acronyms used in this Consultation Paper

AADB	Accountancy & Actuarial Discipline Board
APB	Auditing Practices Board
CASS	Client Assets Sourcebook
CBA	Cost Benefit Analysis
CP	Consultation Paper
DP	Discussion Paper
EEA	European Economic Area
FRC	Financial Reporting Council
FSA	Financial Services Authority
FSMA	Financial Services and Markets Act 2000
ICAEW	Institute of Chartered Accountants in England and Wales
LBIE	Lehman Brothers International (Europe)
MiFID	Markets in Financial Instruments Directive
PS	Policy Statement
SUP	Supervision Sourcebook
the Treasury	Her Majesty's Treasury

1 Overview

Introduction

- 1.1 The purpose of this Consultation Paper (CP) is to set out the recent actions we have taken to improve the quality of the auditor's report on client assets, and to seek your views on our proposals for Handbook amendments. These proposals aim to: confirm and clarify the standards required for the auditor's report on client assets; increase and make consistent the information provided within the auditor's report to enhance its supervisory value; and improve firms' governance oversight of both their auditors and their compliance with the Client Assets Sourcebook (CASS).
- 1.2 Client asset protection is a key aspect of maintaining market confidence, financial stability and consumer protection. In 2009, we commenced supervisory work that focused specifically on assessing regulated firms' compliance with CASS. Our findings were reported in the Client Money and Asset report in January 2010. This report highlighted concerns over firms' handling of client assets and the action we expect firms to take to address these concerns. The weaknesses discovered in firms include: poor management oversight and control; lack of establishment of trust status for segregated accounts; unclear arrangements for segregating and diversifying client money; and incomplete or inaccurate records, accounts and reconciliations.
- 1.3 We also considered the quality of the periodic reporting on client assets provided by firms' auditors. Through supervisory work we have found evidence of material weaknesses in some of the auditor's reports on client assets that we assessed, including indications that some auditors did not understand the relevant FSA Handbook requirements.
- 1.4 The Treasury's December 2009 consultation on resolution arrangements for investment banks also found that the quality of the auditor's report on client assets could be improved and they have asked us to consider what steps we can take to improve it.¹

1 The Treasury (2009), '*Establishing resolution arrangements for investment banks*' Consultation Paper, December 2009, paragraph 4.58 and question 41.

Background

- 1.5 We had partly relied on external independent assurance to gain comfort that regulated firms have systems adequate to enable them to comply with the client assets regime. This is achieved by periodic reporting by external auditors of firms on the adequacy of firms' client assets systems.
- 1.6 For firms carrying on investment business and holding client money and/or custody assets, we require the auditor to express an opinion as to whether the firm has maintained systems adequate to enable it to comply with the applicable chapters of (CASS)² throughout the period, and that the firm was in compliance at the period end. For firms that carry on investment business but who claim not to hold client money or custody assets, the auditor expresses an opinion on whether anything has come to its attention that causes it to believe that the firm held client money and custody assets during the reporting period.³
- 1.7 The MiFID Implementing Directive sets out that member states shall require investment firms to ensure that their external auditors report at least annually on the adequacy of the investment firm's arrangements for complying with the relevant requirements of MiFID in relation to its client money and assets. This report is to be provided to the competent authority of the home member state of the firm.⁴
- 1.8 Insurance intermediaries that hold client money (subject to CASS 5) in excess of £30,000 are required to appoint an auditor to report on the applicable parts of CASS. However, unlike investment businesses, they are not required to provide a report when holding client money below this threshold, and are not required to provide a negative assurance report when they claim not to hold client money.
- 1.9 In our review of the auditor's reports, we uncovered material failings and weaknesses in a number of reports received. The specific failings include:
 - auditors providing unmodified (i.e. 'clean') reports, despite the firm having committed significant failings of the client asset rules;
 - auditor's reports covering the wrong chapters of CASS;
 - failure to provide the report on client assets because the auditor was not aware of, or did not understand, the reporting requirement on client assets;
 - auditors failing to provide adequate detail on the issues and exceptions identified in their report;
 - auditors submitting their reports several months late (in some instances, they were submitted years after the period they relate to); and
 - some auditor's reports had 'simple errors', such as the auditor not signing or dating the report, quoting the wrong FSA Firm Reference Number, or referring to another firm within the body of the report.

2 SUP 3.10.5R, Client assets report: content.

3 SUP 3.10.4R(2), Client assets report: content.

4 MiFID Implementing Directive (2006/73/EC), Article 20.

- 1.10 Because of the nature and number of issues identified, we concluded that the aforementioned failings are not localised to one or a limited number of auditors, but rather indicate a general deficiency by auditors in applying our requirements relating to client assets, and a need to take steps to improve the quality of the auditor's reports on client assets.

Making the auditor's reporting more effective

- 1.11 In Chapter 2 of this CP we set out the recent steps we have undertaken to make the auditor's reporting more effective.
- 1.12 We launched a specialist unit – the Client Asset Sector – to increase focus on the regulation of client assets in the United Kingdom. The sector, among other things, will monitor the quality of the auditor's reports on client assets to ensure that the steps we are taking lead to improvements in the standards.
- 1.13 We have taken a number of steps to notify firms and their auditors of the material failings and weaknesses we have identified in firms' systems relating to CASS compliance, and our intention to continue to actively monitor the quality of the auditor's reports on client assets.
- 1.14 We have also referred a number of auditors to the Institute of Chartered Accountants in England and Wales (ICAEW) and the Accountancy and Actuarial Discipline Board (AADB) for the auditor's reports on client assets that we believe have failed to meet our requirements.
- 1.15 In a joint Discussion Paper (DP)⁵ with the Financial Reporting Council (FRC) published in June 2010, we set out to stimulate debate on how best to engage auditors to meet our statutory objectives. We also raised the question about whether we should seek an enhanced range of enforcement tools in relation to external auditors.
- 1.16 We intend to continue to use the platform of the DP (and subsequent responses) to evaluate how best to enhance the auditor's reporting on client assets and whether we should seek an enhanced range of enforcement tools. This will be in addition to the Handbook proposals set out in this paper.

Proposed Handbook amendments

- 1.17 In Chapter 3 of this CP we set out our proposals to amend the Handbook. These proposals, together with the other actions we are taking (as summarised in Chapter 2) aim to drive improvements in the quality and consistency of the auditor's reports.

5 FSA and FRC, DP 10/3 'Enhancing the auditor's contribution to prudential regulation' (June 2010).

1.18 We propose a number of amendments that will be applicable to firms and their external auditors, specifically to:

- clarify our expectations by explicitly setting out our requirements for a reasonable assurance report where the firm is holding client money and/or assets, and for a limited assurance report where the firm claims not to hold client money and/or assets;
- detail in guidance that we expect the auditor's report to comply with applicable auditing standards and guidance promulgated by the relevant auditing standard setting bodies, such as the Auditing Practices Board (APB);
- stipulate a template to be used for the auditor's report;
- require the auditor's report to be signed by the individual within the audit firm with primary responsibility for the report in their own name;
- require the auditors to prepare a separate schedule identifying the CASS breaches noted in the firm's systems during the period covered by the auditor's report;
- require regulated firms to set out their comments on actions taken (if any) and/or mitigating factors associated with the breaches the auditor has cited;
- require regulated firms' governing bodies to consider the findings of the auditor's report on client assets;
- bring the Mandate rules (CASS 8) back within the scope of the auditor's report on client assets;
- simplify (without amending policy) our existing rules, contained within SUP 3.1, which stipulate the firm categories that are required to obtain an auditor's report on client assets; and
- require auditors to deliver reports on client assets within four months from the end of the reporting period.

Cost benefit analysis and draft Handbook text

1.19 A cost benefit analysis of our proposals for the Handbook amendments, and their compatibility with our statutory objectives, can be found in Annex 1.

1.20 The draft Handbook text reflecting the proposals set out in Chapter 3 can be found in Appendix 1.

Who should read this CP

1.21 This paper will be of particular interest to:

- regulated firms, particularly those firms that hold and control client money and/or assets, and those firms not holding client money and assets but which carry on designated investment business;

- regulated firms' trade bodies;
- external auditors and their professional bodies; and
- auditing standard setting bodies.

Next steps

- 1.22 Consultation on these proposals will close on 31 December 2010. We intend to consider feedback with a view to publishing a policy statement during the first quarter of 2011.

Consumers

The proposals in this paper enhance the CASS regime, which is designed to give an appropriate level of consumer protection and market confidence. However, we consider the proposals to be most relevant to regulated firms and their auditors.

External advisory group

- 1.23 We established an external advisory group – whose members were representatives from the APB, the auditors' professional bodies and seven audit firms, including small firm representation. This group met during May and June 2010 to discuss the applicable regulatory regime and the issues highlighted by our work in this area.
- 1.24 The group's discussions focused on the:
- scope and type of the CASS auditor's opinion on client assets;
 - format and presentation of the auditor's report on client assets; and
 - the requirements and guidance provided in Chapter 3 of the Supervision Sourcebook (SUP 3) and Auditing Practice Board's Practice Note 21.
- 1.25 The group meetings proved useful in drawing out the issues auditors have identified and areas where they would appreciate further guidance or clarity. In the development of the Handbook policy proposals set out in Chapter 3, we have had regard to the issues and ideas raised from these discussions.
- 1.26 We would like to thank the group members for their contributions to the discussions in the lead up to the development of this CP.

Other client assets related work undertaken in 2010

- 1.27 We have consulted in quarterly consultations to limit the use of Title Transfer Collateral Arrangements and adding guidance to the Money Due and Payable to the Firm provisions (CP10/15). We have also taken the opportunity to correct typographical errors in CASS 7.7.2 R in relation to the statutory trust (CP10/10), which had caused some firms to misunderstand the intended policy.
- 1.28 We published CP10/09, *Enhancing the Client Assets Sourcebook* in March 2010. The CP proposes key enhancements to the CASS regime that address the issues identified from a number of insolvency appointments, including Lehman Brothers International (Europe) (LBIE).
- 1.29 We have conveyed messages through ‘Dear CEO’ letters, which highlight the importance we attach to the adequate protection of client assets and our continued intention to pursue a credible deterrence agenda where we find failings in firms’ systems and controls.

Future work

- 1.30 As we noted in CP10/09, we plan to consult on a number of areas to ensure that the CASS regime delivers the desired level of client protection, financial stability and market confidence. We will continue to work with the Treasury to develop effective and proportionate resolution regimes for firms.
- 1.31 In particular, firms can expect future consultations to focus on:
- improvements to the Part IV permission regime for firms that hold and control client money;
 - the effectiveness of CASS Chapter 7.8 (notification and acknowledgement of trust);
 - a review of CASS 5 General Insurance Intermediaries; and
 - a review of CASS 7 Client Money (once the final judgment in the LBIE client money hearings has been given).

2 Enhancing the auditor's contribution

- 2.1 In the Client Money and Asset report, published in January 2010, we set out our concerns that the auditor's reports on client assets do not currently provide us with the level of independent assurance that we require. This report, and other subsequent communications, notified auditors that we will be actively monitoring their reports on client assets.
- 2.2 We launched a specialist unit – the Client Assets Sector – to increase focus on the regulation of client assets. The sector has brought together staff responsible for policy, data collecting and monitoring and analysis.
- 2.3 As well as continuing to use the auditor's reports on client assets to monitor firms' compliance, the sector will monitor the quality of the auditor's reports on client assets to ensure that the steps we are taking lead to improvements in the standard of auditing and reporting.
- 2.4 Furthermore, earlier this year, we established a referral arrangement for the auditor's reports on client assets that we consider to have failed to meet our requirements. Under this arrangement, we have referred a number of auditors to the Institute of Chartered Accountants in England and Wales (ICAEW) and the Accountancy and Actuarial Discipline Board (AADB) and we are in the process of making further referrals.
- 2.5 In a joint paper with the Financial Reporting Council (FRC), we published Discussion Paper (DP), DP10/3, *Enhancing the auditor's contribution to prudential regulation*. The DP raises a number of questions about the effectiveness of external audits in helping us achieve our statutory objectives. The DP also highlighted the failings we have noted in auditor's reports on client assets, as well as our intention to publish this CP by the end of September 2010.
- 2.6 The DP raised the question about whether we should seek an enhanced range of enforcement tools in relation to auditors. The paper sets out that we need the right range of enforcement powers to enable us to make a fully calibrated response to the level of regulatory concern in any given case, and that the provision of further powers would require amendments to FSMA.⁶

6 FSA and FRC Discussion Paper 10/3, page 39, paragraphs 4.35 to 4.37 and question 7.

- 2.7 The DP asked for respondents' views on whether an appropriate package of enforcement powers could include some or all of the following:
- the power publicly to censure the audit firm or relevant individuals within the audit firm;
 - the power to impose financial penalties against the audit firm or the relevant individuals within the audit firm; and
 - the power to disqualify the audit firm, or relevant individuals within the audit firm, from acting as the auditor of an authorised person or class of authorised person (either by temporary suspension or indefinite disqualification).⁷
- 2.8 We intend to continue to use the platform of the DP (and subsequent responses) to evaluate whether we should seek an enhanced range of enforcement tools to enhance the auditor's reporting on client assets.

7 FSA and FRC Discussion Paper 10/3, page 39, paragraph 4.37.

3 Proposed Handbook amendments to improve the auditor's report on client assets

Scope of our proposals

- 3.1 In this chapter we set out our proposals to amend the Handbook, primarily in Chapter 3 of the Supervision Sourcebook (SUP 3), to:
- confirm and clarify the standards required for the auditor's report on client assets;
 - increase and make consistent the information provided within the auditor's report to enhance its supervisory value; and
 - improve firms' governance oversight of both their auditors and their compliance with CASS.
- 3.2 The proposals in this chapter will apply to the auditor's report on client assets required in SUP 3, and all firms and their external auditors who are currently subject to those requirements.⁸
- 3.3 The proposals in this chapter will not affect the requirements in CASS for written confirmation from the firm's auditor. CASS requires the firm to provide us with written confirmation from the firm's auditor on the firm's systems and controls when it is adopting a different method or an alternative approach for client money and asset reconciliations or segregation from the standard methods set out in CASS.⁹ Firms are reminded that, before adopting a different method or alternative approach to client money and asset reconciliations or segregation, they are required to provide separate written confirmations from their auditor in accordance with the applicable requirements in CASS. The periodic auditor's report on client assets (SUP 3.10) does not fulfil this obligation.

⁸ The proposals will apply to auditors engaged by regulated firms to provide the auditor's report on client assets. A firm is not required to engage the same firm of auditors to provide both the auditor's report on client assets and the statutory audit of its financial statements.

⁹ Circumstances when a written confirmation from the auditor is required in CASS include: i) use of non-statutory client money trust (CASS 5.4.4R(2)); use of alternative reconciliation method for custody assets (CASS 6.5.5R); use of the alternative approach for segregation of client money (CASS 7.4.15R); etc.

Clarifying our expectations regarding the type of report and the applicability of auditing standards

- 3.4 Within SUP 3.10, we set out which parts of CASS the auditor is required to report on. However we do not set out the nature of the auditor's report on client assets. For instance, we do not stipulate whether the report should be a reasonable assurance report or a limited assurance report, and we have found from our discussions with some auditors that they are not always clear about our expectations. Also, in our handbook we do not set out whether we expect the auditor to comply with any applicable standards or guidance established by the relevant auditing standard-setting body in providing us with their report on client assets.
- 3.5 Because of the above, there is potential for disparity between our expectations, the expectations of the auditors, and those of the regulated firms. This disparity could at times have contributed to some auditor's reports on client assets not meeting our expectations.
- 3.6 CASS sets out detailed requirements for the regulated firm to make adequate arrangements to safeguard the clients' ownership rights and minimise the risk of loss in relation to client money and assets. The CASS rules include the internal and external reconciliation requirements, the trust notification and acknowledgement requirements, prompt segregation requirements, etc.
- 3.7 In SUP 3 we require the regulated firm to engage its external auditor to report on whether the firm maintained systems adequate to enable it to comply with the applicable CASS rules.¹⁰ Though the auditor cannot test every transaction or reconciliation, they should obtain sufficient appropriate assurance evidence to reduce its engagement risk to an acceptably low level in order to enable them to opine on the adequacy of the firm's CASS systems.
- 3.8 In collecting their evidence, the auditor may identify instances where the firm has breached the CASS rules.
- 3.9 It is important to recognise that materiality is not a relevant consideration when determining if a CASS rule has been breached. For example, a failure to place client money promptly into a client bank account is a breach of the rules regardless of whether the amount concerned was £5 or £5m. Some firms that hold client money and assets, particularly those with high trading volumes, may on occasion breach some of the individual CASS rules, even though they have in all other respects maintained systems adequate to enable them to comply with CASS.
- 3.10 If the firm has breached CASS rules, we expect the auditor to assess the firms' systems in light of the CASS breaches to determine whether to express a qualified or an adverse opinion. The auditor must consider the nature of any CASS breaches (context, period covered, number of occurrences, etc) to determine whether they indicate a failure to maintain systems adequate to enable the firm to comply with the CASS rules throughout the period, and whether the firm was in compliance with those rules at the end of the period.

¹⁰ SUP 3.10.4R and 3.10.5R; Client assets report content.

Box 3.1 Examples of instances that illustrate and contrast when an auditor's opinion is qualified and when it is adverse

- a. An example of a CASS breach that is likely to lead the auditor to express a qualified opinion:
 - On a few separate occasions the firm failed to promptly place client money (cheques received from clients) into a client bank account, in breach of CASS 7.4.1R. The cause was shown to be human error leading to wrong instructions being sent or items not being processed. The firm did not identify any other similar failures in the year, and the auditor obtained evidence confirming the adequacy of the systems maintained (for example, from a review of the design of the controls and sample testing to ensure the controls were implemented as designed).
- b. The following is an example of a CASS breach that is likely to lead the auditor to express an adverse opinion:
 - The firm failed to undertake internal client money reconciliation, in breach of CASS 7.6.2R. The cause arose from a misunderstanding by the firm of their obligations under CASS rules, leading to the firm failing to implement adequate systems to undertake the internal reconciliation.

Example (a) will not lead to an adverse auditor opinion because the auditor was able to confirm that the firm had otherwise maintained adequate systems to enable it to comply with the requirement to promptly segregate client money. This was supported by the relatively low number of failures evidenced. Nevertheless, the opinion is likely to be qualified because of the nature of the breaches identified (e.g. the auditor expresses an opinion that 'except for the breaches identified, the firm maintained systems adequate to enable it to comply with the applicable rules'). Alternatively, the auditor's opinion is likely to be adverse if they identify that the systems were not adequately maintained to ensure that cheques were promptly segregated (likely to be evidenced in a high failure rate, relative to the volume of cheques received).

In example (b) the firm has failed to implement appropriate systems to undertake the internal reconciliation requirement. There may not have been actual loss incurred by clients by this breach, as it is likely that any loss will only occur if the firm fails. Nevertheless, the auditor will express an adverse opinion as the firm did not have adequate systems to enable it to comply with the client money rules, specifically, in this example, the internal reconciliation requirements.

3.11 We propose to clarify the type of assurance report we require and that we expect the auditor to assess whether the systems maintained by the firm have failed to comply with the individual CASS rules. The auditor should also assess whether the failures are so pervasive that the firm failed to maintain adequate systems to enable it to comply with the CASS rules throughout the period, and whether the firm was in compliance with those rules at the period end. Specifically, we propose to set out the following:

- Where the firm is holding client money and/or assets, the auditor must ensure that the report on client assets is prepared in accordance with the terms of a ‘reasonable assurance engagement’.
- Where the firm claims not to hold client money and/or assets, the auditor must ensure that the report on client assets is prepared in accordance with the terms of a ‘limited assurance engagement’.
- In establishing the reports, the auditor must have regard to the firm’s failures to comply with individual CASS rules. They must use their professional judgement to assess the significance of a rule breach, as well as its context, duration and incidence of repetition. We expect the auditor to consider the aggregate effect of any breaches when judging whether a firm had maintained systems adequate to enable it to comply with the CASS rules, and whether the firm was in compliance with those rules at the period end.

3.12 We propose to define the terms ‘reasonable assurance engagement’ and ‘limited assurance engagement’ with reference to the Auditing Practices Board’s (APB’s) published definitions contained within its publication *Standards and Guidance*. Although our draft rules (see Appendix 1) refer to the 2010 edition of *Standards and Guidance* it is our intention that the rules be continuously updated to refer to the current edition, as long as we think *Standards and Guidance* remain an appropriate point of reference for our rules. We will decide on a case-by-case basis whether consultation is required before updating our rules in this way.

3.13 These proposals will not change the existing wording for the auditor’s opinion set out within SUP 3.10.5. We do not foresee that this will significantly change the work the auditors should have already been undertaking in providing their reports on client assets to date. The purpose of our proposals is to provide greater clarity on our expectations of the auditor’s report so that we can place reliance on the assurances it provides.

Q1: Do you agree that we should stipulate the requirements for a reasonable assurance report where a firm is holding client money and/or assets and a limited assurance report where a firm claims not to hold client money and/or assets? If not, why not?

- 3.14 Auditing and assurance reporting services is not something we regulate. There are standard-setting bodies that provide standards and guidance for auditors to adhere to in respect of the services they provide.¹¹
- 3.15 We do not provide guidance within our rules on the audit process that an auditor should undertake when providing an auditor's report on client assets. We look to the standard-setting bodies to provide the relevant standards and guidance. Most notably in the UK, the Auditing Practice Board (APB), within its Practice Note 21, provides guidance to assist auditors of investment businesses in reporting on client assets. We observed in the reviewed auditor's reports that most claimed to adhere to the guidance set out in Practice Note 21.¹²
- 3.16 Practice Note 21 provides guidance for auditors on topics such as engagement acceptance and continuance procedures, planning and performing the engagement, assessing engagement risk, control objectives etc. We understand from the APB that they intend to review the contents of Practice Note 21 on client asset reporting, with an aim to revise them in the coming year to reflect developments in the CASS rules.
- 3.17 For the above reasons, we propose to make it explicit in our guidance that we expect the auditor's report on client assets to comply with the applicable auditing standards and guidance promulgated by the APB for a UK firm.

Q2. Do you agree that we should set out in guidance that we expect the auditor's report on client assets to comply with applicable auditing standards and guidance promulgated by the relevant auditing standard setting bodies, specifically the APB? If not, why not?

Improving the transparency and consistency of the auditor's reports on client assets

- 3.18 We have seen that there is considerable variation within auditor's reports with the detail they provide on the breaches. For example, some reports set out contextual information on all the breaches identified, while other reports list 'some' of the rules breached, but with no contextual information to the background of the breach. Some reports provide no information on any breaches noted.
- 3.19 We have also seen some auditor's reports signed by the individual audit partner, although most reports are signed in the name of the audit firm.
- 3.20 We do not provide a template for the auditor's report on client assets. Though the APB's Practice Note 21 does provide a template for the auditor's report, it does not set out the extent to which breaches identified by the auditor should be detailed.

11 We require a firm to appoint an auditor eligible for appointment as an auditor under the relevant parts of the Companies Act, or which, for an overseas firm, is eligible for appointment as an auditor under any applicable equivalent laws of that country or territory (see SUP 3.4.2R; Auditors' qualifications).

12 We observe the following explanation in the auditor's reports on client assets: "We have carried out such procedures as we considered necessary for the purposes of this report having regard to Practice Note 21 'The audit of investment businesses in the United Kingdom (Revised)' issued by the Auditing Practices Board".

- 3.21 We propose to establish a standard format for the reporting template. This will include the standard template for the auditor's opinion and a separate template for any breaches of CASS identified – examples of these are included in Annex 3 and 4 respectively. Together these two parts will form the auditor's report on client assets.
- 3.22 The template for the auditor's opinion (Annex 3) meets our existing requirements and largely follows the format set out in APB's Practice Note 21.¹³
- 3.23 As noted above, we observe that most of the auditor's reports on client assets are signed with the name of the audit practice, rather than the individual auditor. We propose amending this by requiring the auditor's report to be signed with the name of the individual with primary responsibility for the report within the audit firm, as set out in the proposed template in Annex 3. This would be similar to the way in which auditor's reports on Statutory Financial Statements are now signed.¹⁴ In doing this we are not proposing to affect the auditor's legal liability or the engagement relationship between the audit firm and the regulated firm (which are determined by the engagement agreements between the firm and the auditor). However, we believe this change will provide a clear focus of accountability and, in doing so, help us to monitor the quality of reports from individual auditors.
- 3.24 The schedule for the auditor to record any breaches of CASS identified (as set out in the proposed template in Annex 4) requires the auditor to clearly identify the CASS rules involved and set out contextual information surrounding each breach identified by them (such as through sample testing) and breaches identified by the firm or any other party (such as in a firm's breaches register). The information contained in the schedule (Annex 4) will not form part of the auditor's opinion (contained in the Annex 3), unless the auditor's opinion makes specific reference to items in the schedule.
- 3.25 The provision of the contextual information on any breaches identified (in addition to the auditor's opinion) would provide important information on the type of breaches experienced by firms. This will permit us to undertake baseline monitoring across firms holding client money and assets. For example, this will allow us to identify whether a firm is an outlier compared to the rest of the sector because of the type or nature of breaches they incur. It will also allow us to identify whether there is need to undertake a thematic review of a specific CASS policy because there are a significant number of firms breaching a particular CASS rule.
- 3.26 We propose to require firms to add their comments alongside the breaches noted by the auditor. This would allow us to understand what actions (if any) the firm has taken to resolve the breaches or any mitigating factors associated with the breaches noted by the auditor. It will be the responsibility of the firm to provide this

13 Auditing Practice Board (2007) *Practice Note 21; The Audit of Investment Businesses in the United Kingdom*, December 2007, Appendix 1, page 90.

14 Since the adoption of the 8th Company Law Directive in 2005, statutory financial statements are signed in the name of the senior statutory auditor (with exemption from the requirement to disclose the auditor's identity where his or her personal security could be at risk.).

information, and the auditor will have no responsibility to ensure the factual accuracy of the information.¹⁵

- Q3. Do you agree with the proposals for our rules to stipulate the template to be used for the format of the auditor's opinion? Do you foresee any difficulties auditors may face in using the proposed template provided in Annex 3?
- Q4. Do you agree with the proposals to require the auditor's opinion to be signed by the individual with primary responsibility for the report within the audit firm?
- Q5. Do you agree that auditors should complete a separate schedule listing the breaches of CASS identified in the firm during the period subject to the auditor's report? Do you foresee any difficulties the auditors may face using the proposed template provided in Annex 4?
- Q6. Do you agree that firms should set out their comments on actions taken (if any) and/or mitigating factors associated with the breach the auditor has cited?
- Do you foresee any difficulties in the firm providing their comments in the proposed template provided in Annex 4?

Clarify the expectations regarding a firm's governing body in relation to its auditor's report on client assets

- 3.27 Reviews undertaken earlier this year identified concerns over oversight of client assets by those charged with governance in the regulated firm; furthermore we have noted that some firms' senior management and governing bodies are not aware of the findings from the auditor's report on client assets. This is likely to have played a part in the poor level of CASS compliance observed at some firms.¹⁶
- 3.28 The firm appoints an external auditor to provide a report on client assets. For investment businesses, the auditor's report on client assets is addressed and submitted to the FSA. However, this does not prevent the firm from assessing the external auditor's findings. On the contrary, as the external auditor's report is used by the FSA to monitor the firm's compliance with our CASS rules, the firm's senior management and governing body should be able to use the report to determine whether they have maintained adequate systems that comply with the applicable CASS rules.

¹⁵ When providing this information in the proposed format, firms are reminded that they will be subject to Principles for Business, specifically Principle 11 a firm must deal with its regulators in an open and cooperative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice.

¹⁶ FSA (2010) *Client Money and Assets report*, January 2001.

- 3.29 The firm could also use the report on client assets to assess whether the auditor has fulfilled the terms of their engagement to the standard required. In this regard firms are reminded that they must take reasonable steps to ensure that the auditor has the required skill, resources and experience to perform its functions.¹⁷
- 3.30 For these reasons, we propose establishing a rule requiring the firm's governing body to consider the findings contained in the auditor's report on client assets, having regard to their obligations to maintain systems adequate for their business and in compliance with the applicable rules.
- Q7. Do you agree that we should require the firm's governing body to consider the findings of the auditor's report on client assets?

Amending and clarifying the scope and submission requirements

- 3.31 The Mandate rules, set out in CASS 8, require firms to maintain adequate records and internal controls regarding the use of written authority from clients to a firm, under which the firm may control a client's assets or liabilities. Such written authorities can include direct debits in favour of the firm or the holding of a client's credit card details.
- 3.32 In November 2007, the Mandate rules were moved out of the client money rules chapters (CASS 4 and CASS 5) and into their own chapter in the Client Assets Sourcebook (CASS 8). However, the references in SUP 3.10 specifying the scope of the auditor's report on client assets were not updated to reflect this change. Accordingly, the scope of the auditor's report on client assets was reduced post November 2007 by excluding the Mandate rules.
- 3.33 The Mandate rules require there to be adequate controls within the firm to prevent the misuse of the authority granted by the client, to protect the clients' monies and assets. The external auditor's report on client assets gives us a tool to enable us to monitor compliance by applicable firms, and alerts us to a situation where a firm has not complied with our rules. For these reasons, we propose to update the relevant rules to bring Mandates once again within the scope of the auditor's report on client assets.
- 3.34 The categories of firms subject to the auditor's report on client assets are set out in SUP 3.1. However, as the types of firms regulated by the FSA have increased, and the types of auditor reporting we require has changed, SUP 3.1 has undergone gradual amendments. These amendments have perhaps led to requirements that are unnecessarily intricate. We propose to use this opportunity to tidy up SUP 3.1, without changing the effect of the existing requirements, so that it is easier for the reader to understand.

17 SUP 3.4.2R; Auditors Qualifications.

- Q8. Do you agree with the proposal to reintroduce Mandates (CASS 8) within the scope of the auditor's report on client assets?
- Q9. Do you agree with our proposals to simplify our existing rules, contained within SUP 3.1, which stipulate the firms that are subject to the auditor's report on client assets?
- 3.35 For insurance intermediaries subject to CASS 5 and the auditor's report on client assets, we require the auditor to provide its report to the firm within four months of the end of the reporting period, and to the FSA upon request, within six years of the end of the period covered.¹⁸ We are not proposing to amend this now, but may reconsider it further when we undertake a general review of CASS 5 (scheduled for 2011).
- 3.36 For other types of firm, our rules require the auditor's report to be submitted to the FSA within a 'reasonable time' from the end of the period covered.¹⁹ We set out in guidance that, under ordinary circumstances, a period of four months is considered a 'reasonable time'.²⁰ However, we noted that a number of reports are provided weeks, sometimes months and even a few years after the four months from the end of the period covered.
- 3.37 Our existing rules stipulate that the period covered by the auditor's report must end not more than 53 weeks after the period covered by the previous report. In practice this has meant that the auditor's reports on client assets are completed annually. However, we do not stipulate that the auditor's report should be completed for a specific calendar period or to cover the same period as the statutory audit. This flexibility means that the firm and its auditor can specify the reporting period that is most convenient for them – for example, taking into consideration availability of resources and cost of doing the work at specific non-busy periods in the calendar year.
- 3.38 For this reason, we consider that four months following the period end is a reasonable time by which the auditor can complete its required testing and submit a report. We propose to amend the existing provisions, removing the existing guidance, so that the auditor's report on client assets must be submitted within four months of the end of the period covered.
- Q10. Do you agree with our proposals to replace the existing guidance with a rule requiring auditors to deliver reports on client assets within four months from the end of the period covered?

18 SUP 3.10.8AR; Client asset report: timing of submission.

19 SUP 3.10.6R; Client asset report: period covered.

20 SUP 3.10.7AG; Client asset report: timing of submission.

Timing

- 3.39 The consultation on these proposals will close on 31 December 2010. We intend to consider feedback and publish a Policy Statement during the first quarter of 2011.
- 3.40 If we proceed with the proposals following this consultation we propose that the auditor's reports for periods ending 30 June 2011 and onwards will be required to meet our new proposals. This will require audit firms to use the new templates and adjust their procedures accordingly in the later half of 2011. This will also allow auditors and firms to embed the new requirements ahead of the auditing busy season in the first quarter of 2012, when they would need to complete the auditor's reports for firms with periods ending 31 December 2011.

Q11. Do you agree with our proposals to have new requirements in place for the auditor's reports for the period ending 30 June 2011 and onwards?

Cost benefit analysis and compatibility statement

1. When proposing new rules, we are obliged (under section 155 of the Financial Services and Markets act 2000 (FSMA)) to publish a cost benefit analysis (CBA), unless we consider that the proposal will give rise to no costs or to an increase in costs of minimal significance. We also provide a CBA for significant proposed guidance relating to rules. The CBA provides an estimate of the costs and an analysis of the benefits that will arise from the proposals. It is a statement of the differences in position that will arise if we implement the proposals and the baseline (broadly speaking, the current position).
2. This CBA draws largely on a survey issued to a sample of audit firms in July 2010 (and other data sources as referenced within the text). This survey sampled a full range of auditing firms, including the largest six firms in the United Kingdom, along with a mix of small and medium-sized audit firms based on the number of auditor's reports on client assets annually submitted to the FSA. The survey was sent to 30 auditing firms, of which 18 responded. The 18 respondents collectively provide auditor's reports on client assets for approximately:
 - 927 firms that undertake investment businesses and hold client money and assets (excluding insurance intermediaries), representing about 38% of the estimated 2,400 total of such firms authorised by the FSA;
 - 270 insurance intermediaries that hold more than £30,000 of client money subject to CASS 5,¹ representing about 15% of the estimated 1,800 total of such firms authorised by the FSA; and
 - 1,400 investment businesses that submit an auditor's report on client assets but claim to not hold client money and assets, and where we can not estimate the size of the total population of firms.
3. All but one of our proposals to amend the Handbook have been included below in the same order they appear in Chapter 3 of this Consultation Paper (CP). Where applicable, we have set out our reasons why we consider that a proposal gives rise to minimal or no costs. As set out below, this is the case for the proposals for

¹ An auditor's report on client assets is only required for insurance intermediaries where the insurance intermediary holds more than £30,000 client money subject to CASS 5.

auditors to follow applicable industry standards, auditor's signature and the four-month submission deadline for the auditor's report on client assets.

4. Our proposal to amend and simplify SUP 3.1 to make it easier to read is not included in this CBA because it does not involve any policy change. This proposal should have no direct impact on the auditor's report on client assets and, as a result, the costs for this proposal are expected to be negligible.

Market and regulatory failure analysis

5. Asymmetric information between firms and their clients means that clients do not always know firms' risk of failure and quality of records management as well as firms themselves. This could limit market participation by some customers, when, for example, it is too expensive for clients to conduct the necessary checks. Also, at the time of a firm's failure, uncertainty about its client assets could affect market confidence, which could affect financial stability negatively.
6. The existing CASS regime aims to mitigate those market failures through, among other things, ensuring client assets are kept separate from those of the firm and establishing where client assets stand in the hierarchy of creditors in the event of firm default. High quality client auditor's reports on client assets can help facilitate FSA monitoring of firms' compliance with the existing CASS regime.
7. The results of the recent review found, amongst other things, a wide variance in the quality of auditor's reports. These were to an extent attributed to a lack of clarity of what is expected in relation to the reports on client assets. The Handbook proposals in this CP, together with the other steps we are taking (summarised in Chapters 1 and 2 of this CP), aim to drive improvements in the quality and consistency of the auditor's reports on client assets. Re-introducing Mandates within the scope of the auditor's report on client assets aims to correct a regulatory failure by restoring our ability to maintain baseline monitoring of firms' compliance with those rules.

Clarifying our expectations regarding the type of report and the applicability of auditing standards

8. The proposal to require a clear statement of the auditor's opinion (i.e. reasonable assurance or limited assurance) will be applicable to all firms that must submit an auditor's report on client assets.
9. Guidance requiring the auditor to adhere to applicable industry standards or guidelines promulgated by the relevant auditing standards-setting bodies will apply to the same set of firms.

Benefits

10. For audit reports that currently do not contain a clear statement of auditor's opinion, the proposals could help improve the standard of those audit reports.

11. By being explicit about our expectations in accordance with the proposals – together with our review of auditor’s report on client assets and discussions with audit firms and regulated firms – will facilitate our monitoring and make supervision and enforcement more effective. This will lead to improved compliance with the CASS regime, which will help ensure the realisation of the overall benefits associated with the CASS regime.
12. The proposals also provide us with a benchmark from which to engage in future discussions with the auditing standard-setting bodies and the auditors responsible for producing the auditor’s report on client assets.

Costs

13. Almost all survey respondents indicated that they already provide, as proposed, either a reasonable assurance or limited assurance type of report.²
14. Two survey respondents (providing reports to firms undertaking investment business and holding client money and assets, excluding insurance intermediaries) suggested that to provide the type of auditor’s opinion we are proposing will produce between two and five hours of additional auditing work per firm. We estimate ongoing annual costs of £280 to £2,500 per firm.³ These two survey respondents represent less than 1% of the regulated firms in the sample that engage in investment business and hold client money and assets (excluding insurance intermediaries). We therefore estimate our proposal on the type of auditor’s opinion to generate an annual cost of £7,000 to £60,000 for the industry.⁴
15. All survey respondents confirmed they already follow the applicable industry standards and guidelines in accordance with our proposals. Therefore our proposal – to make it clear that we expect the auditor’s report on client assets to comply with the applicable auditing standards and guidelines promulgated by the relevant auditing standards-setting bodies – will not generate any additional work.⁵ Accordingly, we expect there will be no cost to the industry as a direct result of this proposal.

Improving the transparency and consistency of the auditor’s reports on client assets

16. Our proposal to require the auditor to set out their exceptions in a specified template, and to require the firm to provide comments on any remedial actions in relation to those exceptions, will be relevant to firms that undertake investment

2 Two of the four survey respondents who suggested that there will be additional costs misunderstood our proposals: their cost estimation was based on a reporting format not proposed in this CP. Accordingly, we have not included the cost estimates from these responses in the CBA.

3 $(£140 \times 2 = £280) - (£500 \times 5 = £2500)$. As represented in our survey responses, this is based on an average range of £140 – £500 per hour in auditing fees.

4 $(2400 \times 1\% \times £280 = £6,720)$; $(2400 \times 1\% \times £2500 = £60,000)$.

5 A few respondents based their results on changing the auditing standard to which they adhere, even though their current standards would comply with the proposals in this CP. If auditors currently follow the relevant and applicable industry standard and guidelines, they are not required to adopt new standards or guidelines under these proposals. For this reason, we have not included these responses as part of this section’s CBA analysis.

business and hold client money and assets (excluding insurance intermediaries) and insurance intermediaries that hold more than £30,000 client money subject to CASS 5. We do not expect these proposals to affect investment businesses that claim not to hold client money and assets, where an auditor's limited assurance report is required to confirm this.⁶

17. Our proposal to require the individual auditor responsible for completion of the auditor's opinion on client assets to sign it will be applicable to all firms that must submit an auditor's report on client assets – including investment businesses that claim to not hold client money and assets but are required to nevertheless submit an auditor's report on client assets.

Benefits

18. For auditor's reports that do not contain any breaches auditors have identified or firms' comments on any remedial actions for those breaches, our proposal would improve the information content of the report, and thereby facilitating our monitoring and supervision of firms' compliance with CASS.
19. Requiring the auditor to sign their report with their own name will enable us to monitor the quality of reports issued by individual partners and will further facilitate supervision (e.g. we would know who to contact if we needed clarification).
20. This could lead to more efficient enforcement. This would also lead to improved compliance with the CASS regime, which will help ensure the realisation of the overall benefits associated with the CASS regime.

Costs

Requiring the auditor to set out breaches and exceptions

21. The majority of respondents indicated that they already collect and report the information contained in the proposed template for the auditor's report on client assets.
22. Five survey respondents – who between them provide auditor's reports on client assets for 79 authorised firms, or roughly 7%⁷ of firms, captured by the sample, and that engage in investment business and hold client money and assets (excluding insurance intermediaries) or are insurance intermediaries that hold more than £30,000 in client money subject to CASS 5 – suggested that collating this data and formatting the proposed template will on average involve one to three hours of additional auditing work per year per firm. If we assume that this same percentage is applicable to the same section of the entire industry, we estimate the cost for our proposal to require the auditor to set out the exceptions they have identified in the proposed template will amount to between £40,000 and £440,000⁸ annually for the industry.

⁶ If this type of firm did hold client money and/or assets, this will be a breach of their Part IV Permissions (not a CASS rule) and the auditor will need to provide a modified opinion specifying the reasons for this opinion. We would not expect the auditor to complete the proposed template.

⁷ (79/1197 is about 7%). See paragraph 2 (927+270=1197).

⁸ For any given firm this represents a cost range of £140 (£140x1) – £1500 (£500x3). As represented in our survey responses, this is based on an average range of £140 – £500 per hour in auditing fees.

Firms' comments

23. The majority of survey respondents indicated that providing firms' comments should not need any additional or different actions than before to maintain compliance with the CASS rules.
24. However, a few survey responses indicated that there would be some costs involved in our proposal to require firms to comment on the breaches and exceptions set out in the proposed template. These responses pointed out that firms will have to complete the act of compiling and providing the information requested.
25. The survey responses that indicated higher-than-minimal costs, noted that it would take firms a maximum of three hours to complete.⁹ Assuming it takes up to three hours for each firm to fill out their comments, we expect this proposal to carry an average ongoing annual cost of roughly £215 per firm.¹⁰ Accordingly, we estimate this proposal to carry an ongoing annual cost to the entire industry of up to about £840,000.¹¹

Auditor's signature

26. We expect there to be no cost implications in requiring the auditor's report on client assets to be signed by the individual within the audit firm with primary responsibility for completion of the report.
27. This proposal will not affect the auditor's legal liability or the engagement relationship between the audit firm and the regulated firm (which are determined by the engagement terms between the firm and the auditor). This is supported by the reasoning contained in the Department of Trade and Industry's February 2005 consultation period response to the Proposal for a European Directive on Statutory Audit of Annual and Consolidated Accounts.¹² The UK government set out its position on the reasonableness of expecting an individual within the audit firm to sign the statutory audit reports (not required under the previous version of the UK Companies Act¹³). At the time, the UK government considered that this change for statutory audit reports would be largely cost neutral for the UK system.¹⁴

9 We have not included two of the survey responses in our assessment of this proposal because these two responses suggested that it would take between two and eight hours for a firm to comment on each individual exception. We consider this amount of time unreasonable for assessing how long it will take firms to complete the task of filling-out their firm's comments.

10 $((£47.81 \times (1+50\%)) \times 3 = £215)$. The figure £47.81 has been obtained from the U.K. Office for National Statistics, *2009 Annual Survey of Hours and Earnings*. We have added 50% to gross hourly pay to reflect the likely cost to the employer. This information can be found in Table 14.5a, code 111, available at: www.statistics.gov.uk/StatBase/Product.asp?vlnk=15313.

11 $((\text{about } £200) \times 4200 = \text{roughly } £840,000)$. These costs are opportunity cost as the corporate management or senior officials should already be in place, but simply need to divert attention from other tasks.

12 Department of Trade and Industry, *Proposal for a European Directive on the Statutory Audit of Annual Accounts and Consolidated Accounts: UK Government Response to the Consultation Process and Updated Regulatory Impact Assessment* (February 2005), available at: www.dti.gov.uk/files/file22807.pdf.

13 Compare the United Kingdom's Companies Act 2006, Section 503 with the previous company law provisions in the Companies Act 1985, the Companies Act 1989 and the Companies (Audit, Investigations and Community Enterprise) Act 2004.

14 They did however find that exemptions to disclose the auditor's identity where his or her personal security could be at risk would carry a cost of roughly £10,000 per annum. However, there will be no need for exemptions in the auditor's report on client assets because this is not a public document.

Clarify the expectations regarding a firm's governing body in relation to its auditor's report on client assets

28. The proposal requiring a firm's governing body to consider the findings contained in the auditor's report on client assets will affect all firms that must submit an auditor's report on client assets.

Benefits

29. A rule requiring a firm's governing body to consider the findings contained in the auditor's report on client assets could ensure that a firm's senior management use the report to help fulfil their existing oversight responsibilities, especially for those firms whose governing bodies currently do not consider the findings contained in the auditor's report. A firm's governing body could also use the report to assess whether the auditor has fulfilled the terms of their engagement to the standard required,¹⁵ which could improve the quality of some auditor's reports and therefore facilitate our monitoring.

Costs

30. Under this proposal, we will require the auditor's report on client assets to be reviewed by a firm's governing body. How the governing body receives and actually conducts their review of the report will remain at the discretion of the firm.
31. From the survey responses, we consider that many firms already fulfil this requirement either formally with the auditor, through a meeting or presentation,¹⁶ or informally through correspondence with the auditing firm. For those firms whose senior management or directors directly received or were presented the auditor's report on client assets, the survey responses indicated that this was typically done by either the compliance officer or finance director. With smaller firms, some auditors indicated that their reports were provided to the chief executive officer, while for large firms, some auditors indicated that they already present their reports to the board of directors.
32. Our proposal is for a firm's governing body to review the findings of the auditor's report. For the purpose of estimating the cost of this proposal to the industry, we have based our calculations on the assumption that auditor's report will be formally presented or discussed in a meeting with the governing body or its committees. We estimate that there will be an additional annual cost of about £200 to £2,000¹⁷ per firm for each firm whose governing body currently does not consider the findings contained in the auditor's report.

15 Under existing rules firms must take reasonable steps to ensure that the auditor has the required skill, resources and experience to perform its function.

16 Ten out of 18 survey respondents indicated that when they have presented their auditor's report to some firms, this is typically to the board of directors or its audit committee.

17 We presume this body or committee will range in size from two to ten members. We understand that it will take the governing body about one hour to review the auditor's report on client assets and as a result we expect that this will result in an ongoing annual opportunity cost for each firm of about £31 to £1,248 assuming one hour of governing body time to cost on average between roughly $((£70 \times (1+50\%)) \times 2 = £210)$ and roughly $((£70 \times (1+50\%)) \times 10 = £2,100)$ on the basis of the Office for National Statistics data.

33. We cannot quantify the total industry cost for this proposal because it was not possible to establish through our survey the proportion of firms already fulfilling the proposed requirement.

Amending and clarifying the scope and submission requirements

34. Our proposals to reintroduce Mandates within the scope of the auditor's report on client assets, and to implement as a rule a four-month deadline for submission of the auditor's report on client assets, will affect all firms that require an auditor's report on client assets.

Benefits

35. The proposal to reintroduce Mandates within the scope of the auditor's report on client assets remedies the November 2007 reduction in the scope of the auditor's report. The Mandate rules are designed to ensure adequate controls within a firm to prevent the misuse of the authority granted by the client. When the Mandate rules were removed from the scope of the auditor's report on client assets, we lost an important supervisory tool to identify firms that have failed to comply with those requirements. Reintroducing the Mandate rules within the scope of the auditor's report on client assets will restore this tool, increasing our ability to maintain baseline monitoring of firms' compliance.
36. Implementing a four-month deadline for the submission of the auditor's report on client assets will help us obtain up-to-date and relevant market data. Therefore this could facilitate our supervision and monitoring capabilities.

Costs

Reintroducing Mandates

37. Survey respondents indicated that reintroducing Mandates within the scope of the auditor's report on client assets should generally only affect larger firms. For the purpose of the survey, larger firms were those that hold more than £1m in client money or more than £10m in client assets (excluding insurance intermediaries). This proposal will not generate a cost for firms that do not hold Mandates. We received a range of responses on the amount of additional auditing work this proposal could produce.¹⁸
38. For larger firms (i.e firms that engage in investment business and hold more than £1m in client money or more than £10m in client assets (excluding insurance intermediaries)), reintroducing Mandates within the scope of the auditor's report will generate on average between seven and 20 hours of additional auditing work.¹⁹

18 In our cost analysis for reintroducing Mandates we did not include the response from two survey respondents. These suggested a range of additional auditing work that was two to three times more time intensive than the amount of auditing work suggested by the remaining 16 respondents, making them a significant outlier with no justification provided. Based on this and our experience, we decided to disregard these responses.

19 The range reflects the lowest and highest figures provided by the survey respondents for this category of firm (see note 18).

This translates to an increase in annual ongoing costs, reflected in higher auditor fees, on average of about £1,000 to £10,000 per larger firm.²⁰

39. For all other relevant firms (both smaller investment firms and insurance intermediaries), reintroducing Mandates within the scope of the auditor's report on client assets will generate on average between two and seven hours of additional external auditing work.²¹ We estimate that for all other relevant firms this will lead to an increase in annual ongoing costs, reflected in higher auditor fees, on average of about £300 to £3,500 per firm in this category.²²
40. Based on this information, we estimate the total cost for firms that engage in investment business and hold client money and assets to be around £5m.²³ For insurance intermediaries that hold more than £30,000 in client money subject to CASS 5, we estimate the total industry on-going cost to be roughly £2.5m.²⁴
41. The ongoing costs provided above are likely to be overestimates of the additional work required over coming years, because in the years subsequent to the first, lessons learnt are likely to create efficiencies. We cannot quantify the total industry cost for firms that engage in investment business but claim not to hold client money and assets, because our statistics on these firms are incomplete.
42. We recognise that some firms may incur some one-off costs. Some survey respondents suggested that these proposals would initially involve additional planning and development to create a new auditing programme for Mandates for their specific client.²⁵ These same respondents suggested that the one-off costs would probably only be of significance to large firms.
43. We have not been able to quantify a total impact from one-off costs. We assume that any one-off costs that auditors incur will be passed on in the individual fees they charge to applicable firms across the industry. We expect these costs to be minimal since, as recently as October 2007, Mandates were part of the normal reporting requirements for the auditor's report on client assets. As a result, much of the professional experience, auditing programmes and functions should still be recoverable by auditing firms.

20 $(£140 \times 7 = £980) - (£500 \times 20 = £10,000)$.

21 See note 19.

22 $(£140 \times 2 = £280) - (£500 \times 7 = £3,500)$.

23 Based on our records, our estimates are that there are roughly 400 larger firms and 2,000 smaller firms representing a total of roughly 2,400 firms.

Taking the mid-point of the range of potential fees we expect firms to incur (£5,500 for larger firms and £1,400 for smaller firms), the estimated total industry cost for firms that engage in investment business and hold client money and assets is probably around 5 million $((£5500 \times 400) + (£1,400 \times 2000) = £5m)$.

24 Taking the potential additional auditor fees of £1,400 for insurance intermediaries, the estimated total industry cost for insurance intermediaries who hold more than £30,000 in client money subject to CASS 5 is probably around £2.5 million $(£1400 \times 1800 = £2.52m)$.

25 Note, as recently as October 2007, our normal reporting requirements would have necessitated procedures in place to audit compliance with the Mandate rules. These procedures would be a good place to start in developing new auditing procedures if the Mandate rules are reincorporated within the scope of the auditor's report on client assets. This suggests that the costs reported in the survey are an overestimate.

Four-month submission deadline

44. All except one survey respondent indicated that there would be no additional costs to implement a four-month submission deadline. All of the survey respondents reported that this is already their normal business practice. One respondent suggested there could be an increase of £250 to £500 in fees charged per firm if the auditor's report on client assets had to be produced during the months of January to April. This assumes, however, that the regulated firm maintains a reporting period ending on 31 December. It is important to note that the current rules do not require, nor do these proposals suggest, that the reporting period end on this date. So it is not possible to attribute this cost to our proposals.

Q12: What are your views on the benefits and costs of the proposed policy measures?

Compatibility statement

45. This section explains our reason for concluding that the proposals set out in this CP are compatible with our general duties under Section 2 of FSMA and our regulatory objectives as set out in Sections 3 to 6.
46. We have had regard to the principles of good regulation and consider these proposals to be the most appropriate way of meeting our statutory objectives.

Compatibility with our statutory objectives

47. Our statutory objectives are set out in section 2(2) of FSMA. The existing CASS regime helps ensure that client assets are kept separate from those of the firm and establishes where client assets stand in the hierarchy of creditors in the event of firm default. Asymmetric information between firms and their clients means that clients do not always know a firm's risk of failure and quality of records and records management as well as the firm itself. This can limit market participation by some clients, when, for example, it is too expensive for clients to conduct the necessary checks. Harm to retail consumers may arise where they are the ultimate investors in professional clients' funds. In addition, at the time of a firm's failure, the uncertainty regarding its client assets can affect market confidence, potentially deteriorating financial stability.
48. By facilitating our monitoring of firms' compliance with the existing CASS regime, the proposals in this CP relate to our consumer protection, market efficiency, market confidence and financial stability objectives.
49. By clarifying our expectations of the format and content of the auditor's report on client assets, by increasing the transparency of the auditing process and by standardising the reporting requirements, our proposals will ensure that we are receiving relevant information in a timely manner. Access to up-to-date and quality data is critical for effectively conducting our monitoring and enforcement functions as a regulator in relation to client assets. This data allows us to appropriately evaluate firm and market risks and to take the actions necessary to mitigate these

risks. Moreover, directly involving the governing body in the auditor's report on client assets will ensure greater firm oversight of its compliance functions and systems, potentially also improving incentives for compliance.

50. These proposals are also critical for meeting out regulatory responsibilities under the Markets in Financial Instruments Directive 2004/39/EC (21 April 2004) (MiFID). MiFID obligations include a requirement for investment firms to ensure that their external auditors report at least annually on client assets.²⁶ In complying with our European obligations, this aspect of our proposals should increase confidence in the UK market.

Compatibility with the need to have regard to the principles of good regulation

51. Section 2(3) of FSMA requires that, in carrying out our general functions, we must have regard to a number of specific matters. Of these, our proposed amendments relate to the principles of proportionality, role of management and competitiveness.
52. We have had regard to the principle of proportionality in good regulation. Given our understanding of the way the firms and their auditors operate, we consider that the costs associated with the proposed amendments to be proportionate to the expected benefits. The cost benefit analysis provides an analysis of the benefits and estimates of the main expected costs of the proposals. Based on this, we consider that the benefits of the proposals are likely to outweigh the costs.
53. We have had regard to the requirement to minimise the adverse effects on competition that may arise from our activities and the desirability of facilitating competition between the firms we regulate. Specifically, we consider that the proposed changes will not have a cost impact on firms that is sufficiently material to impact competition.
54. We have also had regard of the role of management, recognising that a firm's senior management is responsible for its activities and for ensuring that its business complies with regulatory requirements. The changes we propose increase the focus a firm's governing body has on the auditor's report, and this CP reminds firms that they are responsible for the appointment of an auditor who has the required skill, resources and experience to perform their functions.

26 MiFID Implementing Directive (2004/39/EC), Article 20.

List of consultation questions

- Q1: Do you agree that we should stipulate the requirements for a reasonable assurance report where a firm is holding client money and/or assets and a limited assurance report where a firm claims not to hold client money and/or assets? If not, why not?
- Q2: Do you agree that we should set out in guidance that we expect the auditor's report on client assets to comply with applicable auditing standards and guidance promulgated by the relevant auditing standard setting bodies, specifically the APB? If not, why not?
- Q3: Do you agree with the proposals for our rules to stipulate the template to be used for the format of the auditor's opinion? Do you foresee any difficulties auditors may face in using the proposed template provided in Annex 3?
- Q4: Do you agree with the proposals to require the auditor's opinion to be signed by the individual with primary responsibility for the report within the audit firm?
- Q5: Do you agree that auditors should complete a separate schedule listing the breaches of CASS identified in the firm during the period subject to the auditor's report? Do you foresee any difficulties the auditors may face using the proposed template provided in Annex 4?

Q6: Do you agree that firms should set out their comments on actions taken (if any) and/or mitigating factors associated with the breach the auditor has cited?

Do you foresee any difficulties in the firm providing their comments in the proposed template provided in Annex 4?

Q7: Do you agree that we should require the firm's governing body to consider the findings of the auditor's report on client assets?

Q8: Do you agree with the proposal to reintroduce Mandates (CASS 8) within the scope of the auditor's report on client assets?

Q9: Do you agree with our proposals to simplify our existing rules, contained within SUP 3.1, that stipulate the firms that are subject to the auditor's report on client assets?

Q10: Do you agree with our proposals to replace the existing guidance with a rule requiring auditors to deliver reports on client assets within four months from the end of the period covered?

Q11: Do you agree with our proposals to have the new requirements in place for the auditor's reports for the period ending 30 June 2011 and onwards?

Q12: What are your views on the benefits and costs of the proposed policy measures?

Draft template: Auditor's report on client assets Part 1 – Auditor's opinion

Independent auditor's report on client assets to the Financial Services Authority in respect of [Firm name], FSA reference number [number], for the period ended [dd/mm/yyyy].

Part 1: Auditor's opinion on client assets

We report in respect of [*Firm name*] ('the firm') on the matters set out below for the period ended [*dd/mm/yyyy*].

Our report has been prepared as required by SUP 3.10.4R and is addressed to the Financial Services Authority ('the FSA') in its capacity as regulator of financial services firms under the Financial Services and Markets Act 2000.

Basis of opinion

We have carried out such procedure as we considered necessary for the purposes of this report in accordance with [*specify Standard/Guidance used*] issued by the [*specify organisation name*].

This opinion relates only to the period ended [*dd/mm/yyyy*] and should not be seen as providing assurance as to any future position, as changes to systems or control procedures may alter the validity of our opinion.

Opinion

In our opinion:

[The firm has maintained / Except for... the firm has maintained / Because of... the firm did not maintain] systems adequate to enable it to comply with [the custody rules,] [the collateral rules] [and] [the client money rules] throughout the period since the last date at which a report was made.*

[The firm was / Except for... the firms was / Because of... the firm was not] in compliance with the [the custody rules,] [the collateral rules] [and] [the client money rules] as at the period end date.*

The scope of the firm's permissions did not allow it to hold [client money] [or] [custody assets].

The directors have stated the firm did not hold [client money] [or] [custody assets] during the period. Based on review procedures performed, nothing has come to our attention that causes us to believe that the firm held [client money] [or] [custody assets] during the period.

[In our opinion, [*name of nominee companies*], subsidiaries of the firm which are nominee companies in whose name custody assets are registered, maintained throughout the year systems for the custody, identification and control of custody assets which:

- a) are adequate; and
- b) included reconciliations at appropriate intervals between the records maintained (whether by the firm or the nominee company) and statements or confirmations from custodians or from the person who maintains the record of legal entitlement.] **

[In relation to the secondary pooling event during the period, the firm has complied with the rules in CASS 7A (client money distribution) in relation to that pooling event.]

Other matters

The report should be read in conjunction with the Breaches Schedule that we have prepared and that is appended to it. [Our opinion expressed above does not extend to the Breaches Schedule.]

[*Signature of the partner/individual with primary responsibility within the audit firm*]

[*Typed name of signing individual*]

for and on behalf of [*Name of the audit firm*]

[*registered office*]

[*Date report*]

Instructions for Part 1:

* If the auditor expresses an adverse opinion (i.e. states the firm 'did not maintain...' or 'was not in compliance...') he or she should set out the reasons why. This can be done by reference to items in columns A to D in Part 2 (see Annex 4) of the auditor's report on client assets.

If the auditor expresses a qualified opinion (i.e. states 'except for ..., the firm did maintain' or 'except for ..., the firm was in compliance') he or she should do so by reference to items in columns A to D in Part 2 of the auditor's report on client assets. The auditor should provide a 'nil' return for Part 2 of the report when no CASS breaches have been observed.

** In accordance with SUP 3.10.5(3), the opinion relating to the nominee company is only required to be included in the case of an investment management firm, personal investment firm, a UCITS firm, securities and futures firm or BIPRU investment firm, when a subsidiary of the firm is a nominee company in whose name custody assets are registered.

Draft Template: Auditor's report on client assets Part 2 – Breaches Schedule

Part 2: Identified CASS Breaches that have occurred during the period

[Firm name], FSA reference number [number], for the period ended [dd/mm/yyyy].

In accordance with SUP 3.10.[X] Columns A to D are to be completed by and are the responsibility of the auditor. In accordance with SUP 3.11.[X] Column E is to be completed by and is the responsibility of the firm. The auditor has no responsibility for the content of Column E.

Column A	Column B	Column C	Column D	Column E
Item no.	Rule reference(s)	Identifying party	Breach identified	Firm's comment
1				
...				

Instructions for Part 2:

In Columns A to D of the above schedule the auditor is to set out all the breaches of CASS by the firm occurring during the period subject to the auditor's report, if any. These must include the breaches the auditor has identified through their work (such as in the sample testing of reconciliations) and breaches identified by the firm or any other party (such as those included in the firm's breaches register).

In Column E the firm should set out any remedial actions taken (if any) associated with the breaches cited, together with an explanation of the circumstances that give rise to the breach in question.

Column A	Column B	Column C	Column D	Column E
Item no.	Rule reference(s)	Identifying party	Breach identified	Firm's comment
The auditor would provide here a row number.	The auditor would cite here the CASS rule(s) implicated.	Set out whether the firm, the auditor or other party identified the breach.	The auditor would provide here a description of the breach identified during the period with relevant contextual information.	The firm would provide here a description of the remedial actions taken (if any) and/or mitigating factors associated with the breach the Auditor has cited.
1	CASS 7.4.1	Firm	The firm has identified 12 instances during the period where it failed to promptly deposit client cheques into a client bank account in breach of CASS 7.4.1. The highest amount was for £1,475.67 and the longest period was for 3 business days.	These instances were picked-up through our regular monitoring controls, reported to compliance, and rectified on the same day they were identified. The cause of these breaches was human error. As part of their annual audit plan, our internal auditors undertook reviews of the relevant controls and assessed their adequacy. No further remedial actions were required.
2	CASS 7.8.1R(2)	Auditor	In February 2009 the firm opened a new client bank account with a UK Bank. The firm did send a notification of trust letter, but did not receive an acknowledgement from the bank and continued to place client money in the account in breach of CASS 7.8.1R(2). At period end the account held approximately £1.56 million.	Trust acknowledgement letter has now been received for this account. The account opening check list has now been updated to ensure that a new client bank account cannot be used without first receiving an acknowledgement of trust letter from a bank.

Draft Handbook text

**SUPERVISION MANUAL (AUDITOR'S REPORT ON CLIENT ASSETS)
(AMENDMENT) INSTRUMENT 2011**

Powers exercised

- A. The Financial Services Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):
- (1) section 138 (General rule-making power);
 - (2) section 156 (General supplementary powers);
 - (5) section 157(1) (Guidance); and
 - (4) section 340 (Appointment).
- B. The rule-making powers listed above are specified for the purpose of section 153(2) (Rule-making instruments) of the Act.

Commencement

- C. This instrument comes into force on 1 June 2011.

Amendments to the Handbook

- D. The modules of the FSA's Handbook of rules and guidance listed in column (1) below are amended in accordance with the Annexes to this instrument listed in column (2).

(1)	(2)
Glossary of definitions	Annex A
Supervision manual (SUP)	Annex B

Citation

- E. This instrument may be cited as the Supervision Manual (Auditor's Report on Client Assets) (Amendment) Instrument 2011.

By order of the Board
[] 2011

Annex A

Amendments to the Glossary of definitions

Insert the following new definitions in the appropriate alphabetical position. The text is not underlined.

limited assurance engagement a 'limited assurance engagement' as described in the Auditing Practices Board Standards and Guidance issued in 2010.

reasonable assurance engagement a 'reasonable assurance engagement' as described in the Auditing Practices Board Standards and Guidance issued in 2010.

Annex B

Amendments to the Supervision manual (SUP)

In this Annex, underlining indicates new text and striking through indicates deleted text, unless otherwise stated.

3.1.2 R Applicable sections (see SUP 3.1.1 R)

	(1) Category of firm	(2) Sections applicable to the firm	(3) Sections applicable to its auditor
(1)	<i>Authorised professional firm</i> which is required by <i>IPRU(INV)</i> 2.1.2R to comply with chapters 3, 5, 10 or 13 of <i>IPRU(INV)</i> and which has an auditor appointed under or as a result of a statutory provision other than in the <i>Act</i> (Note 1)	SUP 3.1 - SUP 3.7 ₂ <u>SUP 3.11</u>	SUP 3.1, SUP 3.2, SUP 3.8, SUP 3.10
(2)	<i>Authorised professional firm</i> not within (1) to which the <i>custody chapter</i> or <i>client money chapter</i> applies, unless the firm is regulated by The Law Society (England and Wales), The Law Society of Scotland or The Law Society of Northern Ireland (Note 2)	SUP 3.1 - SUP 3.7 ₂ <u>SUP 3.11</u>	SUP 3.1, SUP 3.2, SUP 3.8, SUP 3.10
...			
(4)	<i>Bank, building society</i> or <i>dormant account fund operator</i> which in each case carries on <i>designated investment business</i> (Note 2A)	SUP 3.1- SUP 3.7 ₂ <u>SUP 3.11</u>	SUP 3.1, SUP 3.2, SUP 3.8, SUP 3.10
...			
(7)	<i>Investment management firm</i> , (other than an <i>exempt CAD firm</i>), <i>personal investment firm</i> (other than a <i>small personal investment firm</i> or <i>exempt CAD firm</i>) or <i>securities and futures firm</i> (other than an <i>exempt CAD firm</i> or an <i>exempt BIPRU commodities firm</i>) which, in each case, has an auditor appointed under or as a result of a statutory provision other than in the <i>Act</i> (Notes 3 and 3A)	SUP 3.1 - SUP 3.7 ₂ <u>SUP 3.11</u>	SUP 3.1, SUP 3.2, SUP 3.8, SUP 3.10
(7A)	<i>Investment management firm</i> (other than an <i>exempt CAD firm</i>), <i>personal</i>	SUP 3.1 - SUP 3.7 ₂	SUP 3.1, SUP 3.2,

	<i>investment firm</i> (other than a <i>small personal investment firm</i> or <i>exempt CAD firm</i>); or <i>securities and futures firm</i> (other than an <i>exempt CAD firm</i> or an <i>exempt BIPRU commodities firm</i>) not within (7) to which the <i>custody chapter</i> or <i>client money chapter</i> applies	<u>SUP 3.11</u>	SUP 3.8, SUP 3.10
(7B)	<i>UCITS firm</i>	SUP 3.1 - SUP 3.7, <u>SUP 3.11</u>	SUP 3.1, SUP 3.2, SUP 3.8, SUP 3.10
(7C)	<i>UK MiFID investment firm</i> , which has an auditor appointed under or as a result of a statutory provision other than in the <i>Act</i> (Note 3B)	SUP 3.1 - 3.7, <u>SUP 3.11</u>	SUP 3.1, SUP 3.2, SUP 3.8, SUP 3.10
(7D)	<i>Sole trader</i> or <i>partnership</i> that is a <i>UK MiFID investment firm</i> (other than an <i>exempt CAD firm</i>) (Note 3C)	SUP 3.1 - SUP 3.7, <u>SUP 3.11</u>	SUP 3.1, SUP 3.2, SUP 3.8, SUP 3.10
...			
(10)	<i>Insurance intermediary</i> (other than an <i>exempt insurance intermediary</i>) to which the <i>insurance client money chapter</i> (except for CASS 5.2 (Holding money as agent)) applies (see Note 4)	SUP 3.1 - SUP 3.7, <u>SUP 3.11</u>	SUP 3.1, SUP 3.2, SUP 3.8, SUP 3.10
...			
...			
<p>Note 2 = In row (2):</p> <p>(a) The <i>non-directive custody chapter</i> is treated as applying only if (i) the <i>firm safeguards and administers investments</i> in connection with <i>managing investments</i> (other than when acting as trustee) or (ii) it safeguards and administers investments in relation to <i>bonded investments</i> (and, in either case, it has not opted to conduct all business that would fall within the <i>non-directive custody chapter</i> under the <i>MiFID custody chapter</i>).</p> <p>(b) The <i>non-directive client money chapter</i> is treated as applying only if the <i>firm</i> receives or holds <i>client money</i> other than under an arrangement where commission is rebated to the <i>client</i> (and assuming that it has not opted to conduct all business that would fall within the <i>non-directive client money chapter</i> under the <i>MiFID client money chapter</i>); but, if the <i>custody rules</i> or the <i>client money rules</i> above are treated as applying, then SUP 3.10 (Duties of auditors: notification and report on client assets) applies to the whole of the business within the scope of the <i>custody rules</i> or the <i>client money rules</i> above. [deleted]</p>			
<p>Note 2A = For this purpose, <i>designated investment business</i> does not include either or both:</p> <p>(a) <i>dealing</i> which falls within the exclusion in article 15 of the <i>Regulated Activities Order</i> (Absence of holding out etc) (or agreeing to do so); and</p> <p>(b) <i>dealing in investments as principal</i> (or agreeing to do so):</p> <p>(i) by a <i>firm</i> whose <i>permission to deal in investments as principal</i> is subject to a</p>			

limitation to the effect that the *firm*, in carrying on this *regulated activity*, is limited to entering into transactions in a manner which, if the *firm* was an *unauthorised person*, would come within article 16 of the *Regulated Activities Order* (Dealing in contractually based investments); and
(ii) in a manner which comes within that *limitation*;
having regard to article 4(4) of the *Regulated Activities Order* (Specified activities: general).

...

Note 3A = If the *firm* has elected to comply with the *MiFID custody chapter* or the *MiFID client money chapter* also in respect of its *non-MiFID business* then SUP 3.10 will apply to the whole of the business within the scope of the *MiFID custody chapter* or the *MiFID client money chapter*.~~[deleted]~~

...

Note (6) = Unless a *firm* falls within any of the categories in row 2, 7A, or 10, where SUP 3.11 applies to that *firm*, and SUP 3.10 applies to the auditor of such a *firm*, those sections apply whether or not that *firm's permission* prevents it from holding *client money* or *custody assets* and whether or not it holds *client money* or *custody assets*.

...

Authorised professional firms

3.1.8 G This chapter applies to an *authorised professional firm* as set out in rows (1) to (3) of SUP 3.1.2 R: ~~[deleted]~~

- (1) a *firm* in row (1) is treated in the same way as its equivalent in row (7);
- (2) large parts of this chapter apply to a *firm* in row (2) and its auditor; the report on client assets under SUP 3.10 (Duties of auditors: notification and report on client assets) must cover compliance for the whole of the business within the scope of whichever of the *custody rules* and the *client money rules* are treated as applying; but there is no requirement for the auditor to prepare a report to the *FSA* on the *firm's* financial statements
- (3) this chapter has limited application to a *firm* in row (3) and its auditor.

...

...

3.10 Duties of auditors: notification and report on client assets

Application

3.10.1 R Where this section requires an auditor of a *firm* to report on a *firm's* compliance with *rules*, this section applies to the auditor only to the extent

that the *firm* is required to comply with the relevant *rules*. [deleted]

...

Client assets report: content

3.10.4 R An auditor of a *firm* must submit a client assets report addressed to the *FSA*, ~~signed in his capacity as auditor~~, which:

- (1) (a) states the matters set out in *SUP 3.10.5R*; ~~or~~ and
 - (b) where relevant, specifies the matters to which *SUP 3.10.9R* and *SUP 3.10.9AR* refer; or
- (2) if the *firm* claims not to hold *client money* or *custody assets*, states whether anything has come to the auditor's attention that causes him to believe that the *firm* held *client money* or *custody assets* during the period covered by the report.

3.10.4A R (1) For the purpose of *SUP 3.10.4R(1)*, an auditor must ensure that the report is prepared in accordance with the terms of a *reasonable assurance engagement*.

(2) For the purpose of *SUP 3.10.4R(2)*, an auditor must ensure that the report is prepared in accordance with the terms of a *limited assurance engagement*.

3.10.5 R Client assets report

Whether in the auditor's opinion		
(1)	the <i>firm</i> has maintained systems adequate to enable it to comply with the <i>custody rules</i> , the <i>collateral rules</i> and the <i>client money rules</i> (except <i>CASS 5.2</i>) <u>and the <i>mandate rules</i></u> throughout the period since the last date as at which a report was made;	
(2)	the <i>firm</i> was in compliance with the <i>custody rules</i> , the <i>collateral rules</i> and the <i>client money rules</i> (except <i>CASS 5.2</i>) <u>and the <i>mandate rules</i></u> , at the date as at which the report has been made;	
(3)	in the case of an <i>investment management firm</i> , <i>personal investment firm</i> , a <i>UCITS firm</i> , <i>securities and futures firm</i> or <i>BIPRU investment firm</i> , when a <i>subsidiary</i> of the <i>firm</i> is a <i>nominee company</i> in whose name <i>custody assets</i> of the <i>firm</i> are registered, that <i>nominee company</i> has maintained throughout the year systems for the custody, identification and control of <i>custody assets</i> which:	
	(a)	are adequate; and
	(b)	include reconciliations at appropriate intervals between the records maintained (whether by the <i>firm</i> or the <i>nominee</i>

		<i>company</i>) and statements or confirmations from <i>custodians</i> or from the <i>person</i> who maintains the record of legal entitlement; and
(4)		if there has been a <i>secondary pooling event</i> during the period, the <i>firm</i> has complied with the <i>rules</i> in CASS 5.6 and CASS 7A (Client money distribution) in relation to that pooling event.

3.10.5A R In relation to a client assets report provided in accordance with *SUP* 3.10.4R, an auditor must ensure that it:

- (1) is submitted in the form prescribed by *SUP* 3 Annex 1R; and
- (2) is signed on behalf of the audit firm by the individual with primary responsibility for a *firm*'s client assets report and in that individual's own name.

3.10.5B G *SUP* 3.10.4R provides that an auditor must ensure that a client assets report is prepared in accordance with the terms of, as the case may be, a *reasonable assurance engagement* or a *limited assurance engagement*, in either case as those terms are described in the relevant Auditing Practices Board Standards and Guidance. However, the *FSA* also expects an auditor to have regard, where relevant, to material published by the Auditing Practices Board that deals specifically with the client assets report which the auditor is required to submit to the *FSA*. In the *FSA*'s view, a client assets report that is prepared in accordance with that material is likely to comply with *SUP* 3.10.4R and *SUP* 3.10.5R where that report is prepared for a *firm* within the scope of the material in question.

3.10.5C R (1) An auditor must ensure that the information provided to it by a *firm* in accordance with *SUP* 3.11.1R is included in the client assets report.

(2) If by the date at which the report is due for submission in accordance with *SUP* 3.10.7R or *SUP* 3.10.8AR an auditor has not received the information prescribed in *SUP* 3.11.1R it must submit the report without that information, together with an explanation for its absence.

...

Client assets report: timing of submission

3.10.7 R An auditor must deliver a client assets report under *SUP* 3.10.4R to the *FSA* within ~~a reasonable time from~~ four months of the end of each period covered, unless it is the auditor of a *firm* falling within category (10) of *SUP* 3.1.2R.

3.10.7A G ~~A period of four months, in ordinary circumstances, would be considered by the *FSA* as a reasonable time for the auditor to deliver the client assets report to the *FSA*.~~[deleted]

- 3.10.8 R If an auditor fails to comply with SUP 3.10.7R, it must no later than the end of the four month period in question: is unable to report to the FSA within a reasonable time, the auditor must notify the FSA and advise the FSA of the reasons why it has been unable to meet the requirements of SUP 3.10.7 R
- (1) notify the FSA that it is unable to deliver a client assets report by the end of that period; and
 - (2) ensure that the notification in (1) is accompanied by a full account of the reasons for its failure to comply with SUP 3.10.7R.

...

- 3.10.8D R An auditor must:
- (1) deliver to a firm a draft of its client assets report such that the firm has an adequate period of time to consider the auditor's findings and to provide the auditor with comments of the kind prescribed by SUP 3.11.1R; and
 - (2) unless it is the auditor of a firm falling within category (10) of SUP 3.1.2R, deliver to the firm a copy of the final report at the same time as it delivers that report to the FSA in accordance with SUP 3.10.7R.

...

Client assets report: requirements not met or inability to form opinion

- 3.10.9 R If the client assets report under SUP 3.10.4R states that one or more of the applicable requirements described in SUP 3.10.5R has or have not been met, the auditor must specify in the report each of those requirements, and the respects in which it has or they have not been met.
- 3.10.9A R Whether or not an auditor concludes that one or more of the requirements specified in SUP 3.10.5R has or have been met, the auditor must ensure that the client assets report identifies each individual rule in respect of which a breach has been identified.
- 3.10.9B R For the purpose of SUP 3.10.9R and SUP 3.10.9AR, an auditor must ensure that the information prescribed under those rules is submitted to the FSA in the form prescribed by SUP 3 Annex 1R.
- 3.10.9C G (1) The FSA expects that the list of breaches will include every rule breach that is identified in the course of the auditor's review of the period covered by the report, whether identified by the auditor or disclosed to it by the firm, or by any third party.
- (2) For the purpose of determining whether to qualify its opinion or express an adverse opinion, the FSA would expect an auditor to exercise its professional judgment as to the significance of a rule breach, as well as to its context, duration and incidence of repetition.

The FSA would expect an auditor to consider the aggregate effect of any breaches when judging whether a firm had failed to comply with the requirements described in SUP 3.10.5R(1) to (4).

...

3.10.11 G ~~An auditor may at the firm's request include the matters required under this section in a separate report to that required under section SUP 3.9.[deleted]~~

...

After SUP 3.10 insert the following new section. The text is not underlined.

3.11 Firm review of client assets report

3.11.1 R A firm must ensure that:

- (1) it reviews the draft client assets report provided to the firm by its auditor in accordance with SUP 3.10.8DR(1);
- (2) it provides an explanation of:
 - (a) the circumstances that gave rise to each of the breaches identified in the draft report; and
 - (b) any remedial actions that it has undertaken or plans to undertake to correct those breaches; and
- (3) the explanation provided in accordance with (2):
 - (a) is submitted to its auditor in a timely fashion and in any event before the auditor is required to deliver a report to the FSA in accordance with SUP 3.10.7R or to the firm in accordance with SUP 3.10.8AR as the case may be; and
 - (b) is recorded in the relevant field in the draft report submitted to it by its auditor.

3.11.2 R A firm must ensure that the final client assets report delivered to it in accordance with SUP 3.10.8AR or SUP 3.10.8DR is reported to that firm's governing body.

3.11.3 G The FSA expects a firm to use the client assets report as a tool to evaluate the effectiveness of the systems that it has in place for the purpose of complying with requirements to which SUP 3.10.5R refers. Accordingly, a firm should ensure that the report is integrated into its risk management framework and decision-making.

3.11.4 G SUP 3.4.2R provides that a firm must take reasonable steps to ensure that its auditor has the required skill, resources and experience to perform its

functions. The *FSA* expects a *firm* to keep under review the adequacy of the skill, resources and experience of its auditor and should critically assess the content of the client assets report as part of that ongoing review.

After SUP 3.11 insert the following new annex. The text is not underlined.

SUP 3 Annex 1R

Auditor's client assets report Part 1 – Auditor's Opinion

Independent auditor's report on client assets to the Financial Services Authority in respect of [*Firm name*], FSA reference number [*number*], for the period ended [*dd/mm/yyyy*].

Part 1: Auditor's Opinion on Client Assets

We report in respect of [*Firm name*] ('the firm') on the matters set out below for the period ended [*dd/mm/yyyy*].

Our report has been prepared as required by SUP 3.10.4R and is addressed to the Financial Services Authority ('the FSA') in its capacity as regulator of financial services firms under the Financial Services and Markets Act 2000.

Basis of opinion

We have carried out such procedure as we considered necessary for the purposes of this report in accordance with [*specify Standard/Guidance used*] issued by the [*specify organisation name*].

This opinion relates only to the period ended [*dd/mm/yyyy*] and should not be seen as providing assurance as to any future position, as changes to systems or control procedures may alter the validity of our opinion.

Opinion

In our opinion:

[The firm has maintained / Except for...the firm has maintained / Because of...the firm did not maintain] systems adequate to enable it to comply with [the custody rules,] [the collateral rules,] [the mandate rules] [and] [the client money rules] throughout the period since the last date at which a report was made.*

[The firm was / Except for...the firm was / Because of...the firm was not] in compliance with the [the custody rules,] [the collateral rules,] [the mandate rules] [and] [the client money rules] as at the date as at the period end date.*

The scope of the firm's permissions did not allow it to hold [client money] [or] [custody assets].

The directors (or equivalent corporate officers) of the firm have stated that the firm did not hold [client money] [or] [custody assets] during the period. Based on review procedures performed, nothing has come to our attention that causes us to believe that the firm held [client money] [or] [custody assets] during the period.

[In our opinion, [name of nominee companies], subsidiaries of the firm which are nominee companies in whose name custody assets are registered, maintained throughout the year systems for the custody, identification and control of custody assets which:

a) are adequate; and

b) included reconciliations at appropriate intervals between the records maintained (whether by the firm or the nominee company) and statements or confirmations from custodians or from the person who maintains the record of legal entitlement.] **

[In relation to the secondary pooling event during the period, the firm has complied with the rules in CASS 7A (client money distribution) in relation to that pooling event.]

Other matters

The report should be read in conjunction with the Breaches Schedule that we have prepared and which is appended to it. [Our opinion expressed above does not extend to the Breaches Schedule.]

[Signature of the partner/individual with primary responsibility within the audit firm]
[Typed name of signing individual]

for and on behalf of *[Name of the audit firm]*

[registered office]

[Date report]

Instructions for Part 1:

* If the auditor expresses an adverse opinion (i.e. states the firm 'did not maintain...' or 'was not in compliance...') he must set out the reasons why. This can be done by reference to items in columns A to D in Part 2 of the auditor's report on client assets.

If the auditor expresses a qualified opinion (i.e. states 'the except for, the firm did maintain' or 'the except for, the firm was in compliance') he must do so by reference to items in columns A to D in Part 2 of the auditor's report on client assets.

The auditor should provide a 'nil' return for Part 2 of the report when no CASS breaches have been observed.

** In accordance with SUP 3.10.5R(3), the opinion relating to the nominee company is only required to be included in the case of a nominee company in whose name custody assets are registered where that company is a subsidiary of an investment management firm, personal investment firm, a UCITS firm, securities and futures firm or BIRPU investment firm.

Auditor's client assets report Part 2 – Breaches Schedule

Part 2: Identified CASS Breaches that have occurred during the period

[*Firm name*], FSA reference number [*number*], for the period ended
[*dd/mm/yyyy*]

In accordance with SUP 3.10.9AR, Columns A to D are to be completed by and are the responsibility of the auditor. In accordance with SUP 3.11.1R, Column E is to be completed by and is the responsibility of the firm. The auditor has no responsibility for the content of Column E.

Column A	Column B	Column C	Column D	Column E
Item No.	Rule Reference(s)	Identifying party	Breach Identified	Firm's Comment
1				
...				

Instructions for Part 2:

In Columns A to D of the above schedule the auditor is to set out all the breaches of CASS by the firm occurring during the period subject to the auditor's report, if any. These must include the breaches the auditor has identified through their work (such as in the sample testing of reconciliations) and breaches identified by the firm or any other party (such as those included in the firm's breaches register).

In Column E the firm should set out any remedial actions taken (if any) associated with the breaches cited, together with an explanation of the circumstances that gave rise to the breach in question.

SUP TP 1 Transitional Provisions

...

SUP R

TP 1.6

Transitional provisions

(1)	(2)	(3)	(4)	(5)	(6)
	Material to which the transitional provision applies		Transitional Provision	Transitional provision: dates in force	Handbook provisions: coming into force
1	The <i>rules and guidance</i> in SUP 3.10	R	In relation to an auditor of a <i>firm</i> whose client assets report period ends on or before 29 June 2011, that auditor may comply with SUP 3.10 as it was in force on 31 May 2011.	From 1 June 2011	1 June 2011
2	The <i>rules and guidance</i> in SUP 3.11	R	In relation to a <i>firm</i> whose client assets report period ends on or before 29 June 2011, the <i>rules and guidance</i> to which column (2) refers do not apply.	From 1 June 2011	1 June 2011

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