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***Practice
Note***

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**THE AUDIT OF INVESTMENT BUSINESSES
IN THE UNITED KINGDOM**
Revised

The Auditing Practices Board Limited, which is part of the Financial Reporting Council, prepares for use within the United Kingdom and Republic of Ireland:

- Standards and guidance for auditing;
- Standards and guidance for reviews of interim financial information performed by auditors of the entity;
- Standards and guidance for the work of reporting accountants in connection with investment circulars; and
- Standards and guidance for auditors' integrity, objectivity and independence

with the objective of enhancing public confidence in the audit process and the quality and relevance of audit services in the public interest.

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The purpose of Practice Notes issued by the Auditing Practices Board is to assist auditors in applying auditing standards of general application to particular circumstances and industries.

Practice Notes are persuasive rather than prescriptive. However, they are indicative of good practice, even though they may be developed without the full process of consultation and exposure used for auditing standards.

This Practice Note replaces Practice Note 21: 'The audit of investment businesses in the United Kingdom' which was issued in 2000, and Bulletins 2001/7 and 2005/2 are withdrawn.

PRACTICE NOTE 21

THE AUDIT OF INVESTMENT BUSINESSES IN THE UNITED KINGDOM (REVISED)

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PREFACE

This Practice Note contains guidance on the application of auditing standards issued by the Auditing Practices Board (APB) to the audit of investment businesses in the United Kingdom (UK). In addition, it contains guidance intended to assist the auditors of investment businesses in reporting on matters specified by the Financial Services Authority (the FSA) as regulator. Guidance is also given on the auditors' right and duty to report to the regulator.

The Practice Note is supplementary to, and should be read in conjunction with, International Standards on Auditing (ISAs) (UK and Ireland), which apply to all audits undertaken in the UK. This Practice Note sets out the special considerations relating to the audit of investment businesses which arise from individual ISAs (UK and Ireland) listed in the contents. It is not the intention of the Practice Note to provide step-by-step guidance to the audit of investment businesses, so where no special considerations arise from a particular ISA (UK and Ireland), no material is included.

New guidance has been included in the Practice Note in relation to reporting to the FSA on client assets under SUP 3.10, which is applicable whether or not a statutory audit is also carried out. This guidance is set out in the section on Auditor's reports to the FSA.

This Practice Note has been prepared with advice and assistance from staff of the FSA (in so far as the obligations of investment businesses and their auditors under the FSA Handbook are concerned). It is based on the legislation and regulations which are in effect at 31 December 2007. The Practice Note does not however constitute general guidance given by the FSA or Industry Guidance. It is not an exhaustive list of all the obligations that investment businesses and their auditors may have under FSMA and the FSA Handbook.

INTRODUCTION

1. The term 'investment business' in this Practice Note should be taken to refer to firms regulated by the FSA for the conduct of 'designated investment business', as set out in the Glossary to the FSA's Handbook and based upon the Financial Services and Markets Act (FSMA) 2000. Firm types are defined in the Glossary to the FSA Handbook, but the following summary is intended to provide the reader with a broad understanding of the different types of investment business. Rules requiring the application of the Markets in Financial Instruments Directive (MiFID) are complex, and auditors need to consider whether it applies to each investment business they audit.

Type of firm	Short form description of firm	Relevant Prudential sourcebook
BIPRU investment firm (which includes a UCITS investment firm ¹).	Undertakes business within the scope of MiFID, for example a discretionary investment manager or a stockbroker.	GENPRU ² and BIPRU ³
Exempt CAD firm ⁴	Undertakes a restricted level of MiFID scope business for example a securities and futures firm, an investment management firm and a personal investment firm which advises and arranges transactions but does not hold client assets.	IPRU (INV) ⁵ chapters 9 or 13
Securities and futures firm	Undertakes securities and futures business but is not within the scope of MiFID, for example a corporate finance firm which only provides advice.	IPRU (INV) chapter 3
Investment management firm	Undertakes investment management business, which is not within the scope of MiFID, for example the operator of an unregulated collective investment scheme.	IPRU (INV) chapter 5

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- 1 See paragraph 21 for further details of UCITS investment firms and UCITS firms (which are types of UCITS management companies) and the UCITS directive
 - 2 This is the General Prudential sourcebook.
 - 3 This is the Prudential sourcebook for Banks, Building Societies and Investment Firms.
 - 4 For the purposes of the table an exempt CAD firm is shown separately whereas the definitions in the Glossary of securities and futures firm, investment management firm and personal investment firm include an exempt CAD firm.
 - 5 This is the Interim Prudential sourcebook for Investment Businesses.

Personal investment firm	Undertakes investment advisory business for retail clients, which is not within the scope of MIFID, for example an independent financial adviser.	IPRU (INV) chapter 13
UCITS firm ⁶	Operates UCITS schemes, for example an authorised unit trust manager.	UPRU ⁷

2. Investment businesses also include banks and insurers, but guidance for auditors of these businesses is set out primarily in Practice Note 19 – ‘The audit of banks and building societies in the United Kingdom (Revised)’ and in Practice Note 20 – ‘The Audit of insurers in the United Kingdom (Revised)’. It is important to note that this Practice Note does not include within its scope an audit that is required for an investment fund that is managed or operated by an investment business. This would include for example the audit report to the unit holders of an authorised unit trust that is required under the FSA’s Collective Investment Schemes sourcebook (COLL).

The audit reporting requirements of the firms within the scope of this Practice Note are set out in Appendix 7.

3. This Practice Note addresses the responsibilities and obligations of the auditor concerning:
- the audit of the financial statements in accordance with the Companies Act 1985, Limited Liability Partnership Act 2000 and for those incorporated in Northern Ireland the provisions of the Companies (Northern Ireland) Order 1986 (dealt with in paragraphs 29 to 179).
 - the report to the FSA by the investment business’s auditors (dealt with in paragraphs 180 to 263).
 - reporting on interim net profits for the purposes of their inclusion in regulatory capital (dealt with in paragraphs 264 to 270).
 - the right and duty to report direct to the FSA in certain circumstances (dealt with in paragraphs 63 to 93).

This Practice Note does not address other types of work that auditors may also be required to carry out on other areas of an investment business. Auditors in the capacity of independent accountants may, for example be asked to carry out work as a part of an application to become an authorised person; as part of a waiver request; or on cessation of investment business.

⁶ See footnote 1.

⁷ This is the Prudential sourcebook for UCITS Firms.

4. Whilst they are not classed as investment businesses, the parts of this Practice Note giving guidance on financial resources and client assets may be useful to the auditors of intermediary firms⁸ carrying on:
- home finance mediation activities⁹ in relation to regulated home finance transactions
 - insurance mediation activities in relation to 'non-investment' insurance activities

which are regulated by the FSA. In particular there are FSA 'client asset' rules which are applicable to certain insurance intermediaries and on which auditors may be required to report in certain circumstances. Guidance is included in ICAEW TECH 1/06 – Interim guidance for auditors of insurance intermediaries on client asset reporting requirements. The guidance which is included in Appendix 2 of this Practice Note is also likely to be of relevance to the auditors of intermediary firms in relation to the work normally carried out in order to form an opinion on client money in a report to the FSA.

LEGISLATIVE AND REGULATORY FRAMEWORK

Financial Statements

5. The form and content of the financial statements of investment businesses incorporated as limited liability companies in the UK is governed by the Companies Act 1985, Statements of Standard Accounting Practice ('SSAPs'), Financial Reporting Standards ('FRSs') and Urgent Issues Task Force Abstracts ('UITFs'). The mandatory format for investment businesses' financial statements is set out in Schedule 4 to the Companies Act 1985. A Statutory Instrument introduced in 2004 mandates the preparation of consolidated accounts under International Financial Reporting Standards ('IFRS') for listed groups and permits the preparation of accounts under IFRS for other companies.
6. For entities incorporated under the Limited Liability Partnership Act 2000 ('LLPs'), the form and content of the financial statements are governed by the Limited Liability Partnership Regulations. SSAPs, FRSs and UITFs also apply to any financial statements of LLPs intended to give a true and fair view. In addition there is a Statement of Recommended Practice on accounting by LLPs published by the Consultative Committee of Accountancy Bodies. A Statutory Instrument introduced in 2004 permits the preparation of LLP accounts under IFRS.

Financial Services and Markets Act 2000

7. FSMA 2000 sets out the high level regulatory framework for the whole financial sector more generally and not just investment businesses. Appendix 3 sets out the main parts of FSMA 2000 relevant to investment businesses.

8 Home finance intermediaries and insurance intermediaries are defined in the Glossary to the FSA Handbook.

9 Home finance mediation activity includes any mortgage mediation activity, home purchase mediation activity or reversion mediation activity.

8. The wide scope of FSMA 2000 reflects the FSA's extensive responsibilities. These are set out in FSMA 2000 as regulatory objectives covering:
- market confidence;
 - public awareness;
 - the protection of consumers; and
 - the reduction of financial crime.
9. FSMA 2000 covers not only the regulation and supervision of financial sector entities but also other issues such as official listing rules, business transfers, market abuse, compensation and ombudsman schemes, investment exchanges and clearing houses.
10. FSMA 2000 is also supported by a large number of statutory instruments. Significant components of the definition and scope of the regulatory framework are contained in the main statutory instruments.
11. Under Part X FSMA 2000 the FSA has the power to make 'rules'. The legal effect of a rule varies depending on the power under which it is made and on the language used in the rule. Rules are mandatory unless a waiver has been agreed with the FSA. If an authorised firm contravenes a rule it may be subject to enforcement action and consequent disciplinary measures under Part XIV FSMA 2000. Furthermore, in certain circumstances an authorised firm may be subject to an action for damages under s150 FSMA 2000. In contrast, guidance is generally issued to throw light on a particular aspect of regulatory requirements, and is not binding. However if an authorised firm acts in accordance with it in the circumstances contemplated by that guidance, the FSA will proceed on the basis that the authorised firm has complied with the rule to which the guidance relates.
12. Rules made by the FSA and associated guidance are set out in the FSA Handbook of Rules and Guidance ('the FSA Handbook') (see Appendix 4). The main FSA systems and control requirements are set out in SYSC¹⁰.

European Directives

Markets in Financial Instruments Directive ('MiFID')

13. MiFID covers specified 'investment services and activities' and specified 'ancillary services'. The scope of MiFID services and activities falls within the scope of FSMA 2000, although there are a number of additional activities which require authorisation in the UK under FSMA 2000.
14. Where an entity is incorporated in an EEA member state and has obtained authorisation in that state ('home state') for its MiFID investment services, it can provide those

¹⁰ The Senior Management Arrangements, Systems and Controls sourcebook in the FSA Handbook.

authorised services in other EEA member states ('host states') by setting up branches, or by providing services on a cross-border basis, without obtaining separate authorisation in those states. This is referred to as the 'European passport'.

15. Incoming branches of EEA entities which provide investment services in the UK under their passport do still need to be registered with the FSA as an incoming EEA firm; this is achieved by a process of notification to the FSA by the home state regulator, rather than by means of a full-scope application for authorisation.
16. Passports are only available for authorised entities with their head office or registered office in an EEA member state. For example, a UK branch of a US investment business cannot obtain a passport to provide services in other EEA states, although a UK subsidiary can. Also, a passport can only be obtained in respect of services, activities and instruments which are authorised in the home state. For example, where the UK branch of a German investment firm wishes to provide investment services in the UK which are not authorised in Germany, the branch must obtain authorisation from the FSA in addition to its registration as an incoming EEA firm.
17. The home state regulator is responsible for financial supervision of the entity as a whole, i.e. covering head office and any branches. The home state regulator is also responsible for transaction reporting and rules relating to client assets, covering:
 - the investment services provided at home by head office; and
 - the investment services provided by any branches in other European states, where these services are within the entity's passport.
18. The host state regulator is responsible for rules relating to conduct of business excluding transaction reporting and client assets. It is also responsible for client asset rules covering any investment services provided in the host state which are outside the entity's passport.

Capital Requirements Directive ('CRD')

19. MiFID firms will also fall within the scope of CRD which sets out the minimum amounts of regulatory capital MiFID firms must maintain or exceed. CRD also requires MiFID firms to comply with capital adequacy requirements at a group level i.e. they are subject to consolidated supervision.

Financial Groups Directive ('FGD')

20. Firms that are part of a financial conglomerate are required to comply with separate group reporting rules. The FGD also extends the scope of the FSA's supplementary supervision of firms which are part of third country groups, ie those with non-EEA holding companies, to require consideration of risks associated with being a member of that group.

Undertakings for Collective Investment in Transferable Securities Directive ('UCITS')

21. Under the terms of this directive, firms that are authorised to operate UCITS schemes in an EEA member state are allowed to sell such schemes on a cross border basis in other EEA member states without being authorised in those states. Such firms are UCITS management companies and can be either a UCITS firm or a UCITS investment firm. A UCITS firm is one that is the operator of UCITS schemes and may also operate other collective investment schemes which are not UCITS schemes, but carries on no other regulated activities except those that are in connection with or for the purposes of such schemes, and, with respect to prudential requirements, it is subject to UPRU. A UCITS investment firm is one that, as allowed under the terms of this directive, in addition to operating UCITS schemes and, in some cases, other collective investment schemes that are not UCITS, has a permission to manage MiFID investments (and may also in some circumstances have permission to provide investment advice and safeguard and administer investments). With respect to prudential requirements, such a firm is subject to the requirements of BIPRU and GENPRU.

Reporting direct to the FSA – statutory right and duty

22. Under FSMA 2000 (Communications by Auditors) Regulations 2001 (SI 2001/2587) the auditor of an authorised firm (or someone who has been such an auditor) or the auditor of an entity closely linked to an authorised firm (or who has been such an auditor) has a statutory duty to communicate certain matters to the FSA. In addition s342 FSMA 2000 provides that no duty to which the auditor is subject shall be contravened by communicating in good faith to the FSA any information or opinion on a matter that the auditor reasonably believes is relevant to any functions of the FSA. Guidance on the identification of matters to be reported to the regulators is set out in the section dealing with ISA (UK and Ireland) 250 Section B.

Communication between the FSA and the auditor

23. Within the legal constraints that apply, the FSA may pass on to the auditor any information which it considers relevant to his function. An auditor is bound by the confidentiality provisions set out in Part XXIII of FSMA 2000 (Public record, disclosure of information and co-operation) in respect of confidential information the auditor receives from the FSA. The auditor may not pass on such confidential information without lawful authority, for example if an exception applies under the FSMA 2000 (Disclosure of confidential information) Regulations 2001 (SI 2001/2188) or with the consent of the person from whom that information was received and, if different, to whom the information relates.
24. Before communicating to an authorised firm any information received from the FSA, the auditor considers carefully whether:
- the auditor has received the FSA's express permission to communicate a particular item of information;

- the information relates to any other party whose permission may need to be obtained before disclosure can be made;
- the information was received by the FSA in a capacity other than discharging its functions under FSMA 2000 or from another regulator (in which case the auditor may either be prohibited from disclosure or may need permission of the party which provided the information to that regulator).

The auditor may however disclose to an authorised firm information the auditor has communicated to the FSA except where to do so would have the effect of disclosing information communicated to the auditor by the FSA. If there is any doubt the auditor considers the matters above.

25. Matters communicated by the FSA during any bilateral meeting may be conveyed by those representatives of the auditor who were present at the meeting (or otherwise received the communication directly) to other partners, directors and employees of the audit firm who need to know the information in connection with the auditor's performance of its duties relating to that authorised firm and without the FSA's express permission. However in the interests of prudence and transparency the auditor should inform the FSA that they will be discussing the issues covered with colleagues.
26. Where the FSA passes to the auditor information which it considers is relevant to his function, the auditor considers its implications in the context of his work and may need to amend his approach accordingly. However the fact that the auditor may have been informed of such a matter by the FSA does not, of itself, require auditors to change the scope of the work, nor does it necessarily require the auditor actively to search for evidence in support of the situation communicated by the FSA.
27. The auditor is required to cooperate with the FSA (SUP3.8.2R). This may involve attending meetings and providing the FSA with information about the authorised firm that the FSA may reasonably request in discharging its functions. For example this can arise in relation to FSA ARROW II assessments.
28. The auditor must notify the FSA without delay if the auditor is removed from office, resigns before the term of office expires or is not re-appointed by the authorised firm. Notification to the FSA includes communicating any matters connected with this event that the auditor considers ought to be drawn to the FSA's attention or a statement that there are no such matters (s344 FSMA 2000 and SUP3.8.11R and 12R).

THE AUDIT OF FINANCIAL STATEMENTS

ISAs (UK and Ireland) apply to the conduct of all audits. This includes audits of the financial statements of investment businesses. The purpose of the following paragraphs is to identify the special considerations arising from the application of certain ‘bold letter’ requirements to the audit of investment businesses, and to suggest ways in which these can be addressed (extracts from ISAs (UK and Ireland) are indicated by grey-shaded boxes below). This Practice Note does not contain commentary on all of the bold letter requirements included in the ISAs (UK and Ireland) and reading it should not be seen as an alternative to reading the relevant ISAs (UK and Ireland) in their entirety. In addition, where no special considerations arise from a particular ISA (UK and Ireland), no material is included.

ISA (UK AND IRELAND) 200: OBJECTIVE AND GENERAL PRINCIPLES GOVERNING THE AUDIT OF THE FINANCIAL STATEMENTS

Background note

The purpose of this ISA (UK and Ireland) is to establish standards and provide guidance on the objective and general principles governing an audit of financial statements.

The auditor should plan and perform an audit with an attitude of professional scepticism, recognising that circumstances may exist that cause the financial statements to be materially misstated. (paragraph 6)

29. Auditing standards include a requirement for the auditor to comply with relevant ethical requirements relating to audit engagements. In the United Kingdom, the auditor should comply with the APB’s Ethical Standards and relevant ethical guidance relating to the work of the auditor issued by the auditor’s professional body. A fundamental principle is that practitioners should not accept or perform work which they are not competent to undertake. The importance of technical competence is also underlined in the Auditors’ Code¹¹, issued by the APB, which states that the necessary degree of professional skill demands an understanding of financial reporting and business issues. Practitioners should not undertake the audit of investment businesses unless they are satisfied that they have, or can obtain, the necessary level of competence.

¹¹ This is appended to the APB’s Scope and Authority of Pronouncements.

Independence

30. Independence issues can be complex for the auditor of an investment business, because of investments held by the auditor and/or its partners and staff. The auditor makes careful reference to the APB's Ethical Standard 2 – Financial, business, employment and personal relationships on investments by partners and staff in investment businesses.

31. In addition to the APB's Ethical Standards and ethical guidance issued to the auditor by their relevant professional bodies there are rules laid down by the FSA which apply to audit appointments. The FSA rule book (SUP 3.5) sets out circumstances where the auditor would not be viewed by the regulator as independent.

ISA (UK AND IRELAND) 210: TERMS OF AUDIT ENGAGEMENT

Background note

The purpose of this ISA (UK and Ireland) is to establish standards and provide guidance on agreeing the terms of the engagement with the client.

The auditor and the client should agree on the terms of the engagement. (paragraph 2)

The terms of the engagement should be recorded in writing. (paragraph 2-1)

The auditor should ensure that the engagement letter documents and confirms the auditor's acceptance of the appointment, and includes a summary of the responsibilities of those charged with governance and of the auditor, the scope of the engagement and the form of any reports. (paragraph 5-1)

32. The terms of the engagement in respect of auditors' client assets reports to the FSA could be combined with the engagement letter for the statutory audit. In this respect the engagement letter makes it clear that the client assets report is addressed to the FSA. Matters which the auditor may decide to refer to in the engagement letter are as follows:
- the responsibility of the directors/senior management to comply with applicable FSMA 2000 legislation and FSA Handbook rules and guidance including the need to keep the FSA informed about the affairs of the entity;
 - the statutory right and duty of the auditor to report direct to the FSA in certain circumstances (see section of this Practice Note relating to ISA (UK and Ireland) 250 Section B);
 - the requirement to cooperate with the auditor (SUP3.6.1R). This includes taking steps to ensure that, where applicable, each of its appointed representatives and material outsourcers gives the auditor the same right of access to records, information and explanations as the authorised firm itself is required to provide the auditor (s341 FSMA 2000 and SUP 3.6.2G to 3.6.8G). It is a criminal offence for an investment business or its officers, controllers or managers to provide false or misleading information to the auditor s346 FSMA 2000);
 - the need for the investment business to make the auditor aware when it appoints a third party (including another department or office of the same audit firm) to review, investigate or report on any aspects of its business activities that may be relevant to the audit of the financial statements and to provide the auditor with copies of reports by such a third party promptly after their receipt.

33. In this connection the auditor is aware that:

- the FSA does not need to approve the appointment of an auditor but may seek to satisfy itself that an auditor appointed by a firm is independent and has the necessary skills, resources and experience (SUP 3.4.4G, 3.4.7R and 3.4.8G);
- the auditor is required to cooperate with the FSA (SUP 3.8.2R); and
- the auditor must notify the FSA if the auditor ceases to be the auditor of the authorised firm.

ISA (UK AND IRELAND) 220: QUALITY CONTROL FOR AUDITS OF HISTORICAL FINANCIAL INFORMATION

Background note

The purpose of this ISA (UK and Ireland) is to establish standards and provide guidance on specific responsibilities of firm personnel regarding quality control procedures for audits of historical financial information, including audits of financial statements.

Reference should also be made to ISQC (UK and Ireland) 1 – Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and other Assurance and Related Services Engagements.

The engagement partner should be satisfied that the engagement team collectively has the appropriate capabilities, competence and time to perform the audit engagement in accordance with professional standards and regulatory and legal requirements, and to enable an auditor's report that is appropriate in the circumstances to be issued.
(paragraph 19)

34. The nature of investment business is one of rapidly changing and evolving markets. Often investment businesses develop new products and practices which require specialised auditing and accounting responses. It is therefore important that the auditor is familiar with current practice.
35. As well as ensuring that the engagement team has an appropriate level of knowledge of the industry and its corresponding products, the engagement partner also satisfies himself that the members of the engagement team have sufficient knowledge of the regulatory framework within which investment businesses operate commensurate with their roles in the engagement.

ISA (UK AND IRELAND) 240: THE AUDITOR'S RESPONSIBILITY TO CONSIDER FRAUD IN AN AUDIT OF FINANCIAL STATEMENTS

Background note

The purpose of this ISA (UK and Ireland) is to establish basic principles and essential procedures and to provide guidance on the auditor's responsibility to consider fraud in an audit of financial statements and expand on how the standards and guidance in ISA (UK and Ireland) 315 and ISA (UK and Ireland) 330 are to be applied in relation to the risks of material misstatement due to fraud.

In planning and performing the audit to reduce audit risk to an acceptably low level, the auditor should consider the risks of material misstatements in the financial statements due to fraud. (paragraph 3)

The auditor should maintain an attitude of professional scepticism throughout the audit, recognising the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience with the entity about the honesty and integrity of management and those charged with governance. (paragraph 24).

The auditor should make inquiries of management, internal audit, and others within the entity as appropriate, to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity (paragraph 38).

When obtaining an understanding of the entity and its environment, including its internal control, the auditor should consider whether the information obtained indicates that one or more fraud risk factors are present (paragraph 48).

36. As with other entities, either fraudulent financial reporting (for example the manipulation of profits or the concealment of losses) or misappropriation of assets, can occur through a combination of management fraud, employee fraud or fraud perpetrated by third parties.
37. The following are examples of matters that may be relevant when assessing fraud risk in the audit of investment businesses:
 - backlogs in key reconciliations, particularly those with brokers and exchanges and for bank accounts and safe custody accounts – both the investment business's own and those relating to its clients;
 - inadequate segregation of duties between the front, middle and back office staff;

- inadequate whistle blowing arrangements;
- high management and staff turnover levels;
- ineffective oversight of offshore operations;
- lack of an effective audit committee;
- complex products inadequately understood by management;
- inadequate definition of management responsibilities and supervision of staff;
- ineffective personnel practices and policies, e.g. screening of applicants;
- inadequate communication of information to management;
- scope for inappropriate revenue recognition or concealment of trading losses;
- ineffective regulatory compliance monitoring.

38. Whilst remuneration policies can create excessive performance pressures in many industries, in certain types of investment businesses performance related bonuses can be significant both in absolute terms and in relation to base remuneration. In addition significant bonus related remuneration can often extend beyond senior management, further down the organisation of investment businesses, and can lead to more pervasive pressures that cause increased risks of fraud. Other examples of fraud risk factors include:

- valuation of complex financial instruments in an environment where there is inadequate segregation of duties and/or lack of supervision or independent review and/or understanding of the valuation techniques and associated inputs; and
- matters that are subject to significant judgment by management – eg allowances for impairment (particularly collective assessment of impairment) or customer compensation provisioning.

39. Principle 3 of the FSA Principles for Businesses requires a firm to take reasonable care to organise and control its affairs responsibly and effectively with adequate risk management systems. SYSC requires a firm to make and retain adequate records of matters and dealings (including accounting records) which are the subject of requirements and standards under the regulatory system. Whilst the inherent risk of fraud may continue to exist, the establishment of accounting and internal control systems sufficient to meet these requirements frequently reduces the likelihood of fraud giving rise to material misstatements in the financial statements. Guidance on the auditors' consideration of accounting systems and internal controls is provided in the section on ISA (UK and Ireland) 315. Examples of weaknesses in control that could give rise to fraud risk factors are also set out in that section.

When obtaining an understanding of the entity and its environment, including its internal control, the auditor should consider whether other information obtained indicates risks of material misstatement due to fraud (paragraph 55).

40. The auditor considers reports or information obtained from the investment business's compliance department, legal department, and money laundering reporting officer together with reviews undertaken by third parties such as skilled person's reports prepared under s166 FSMA 2000.

If the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor should communicate these matters as soon as practicable to the appropriate level of management (paragraph 93).

The auditor should document communications about fraud made to management, those charged with governance, regulators and others (paragraph 109).

41. Reduction of financial crime is one of the FSA's statutory objectives. The FSA's rules require authorised firms to report 'significant' fraud to the FSA (SUP15.3.17R). The auditor is aware of the auditor's duty to report direct to FSA in certain circumstances (see the section of this Practice Note relating to ISA (UK and Ireland) 250 Section B).

ISA (UK AND IRELAND) 250: SECTION A – CONSIDERATION OF LAWS AND REGULATIONS IN AN AUDIT OF FINANCIAL STATEMENTS

Background note

The purpose of this ISA (UK and Ireland) is to establish standards and provide guidance on the auditor's responsibility to consider laws and regulations in the audit of financial statements.

When designing and performing audit procedures and in evaluating and reporting the results thereof, the auditor should recognize that non-compliance by the entity with laws and regulations may materially affect the financial statements. (paragraph 2)

In accordance with ISA (UK and Ireland) 200, 'Objective and General Principles Governing an Audit of Financial Statements' the auditor should plan and perform the audit with an attitude of professional scepticism recognizing that the audit may reveal conditions or events that would lead to questioning whether an entity is complying with laws and regulations. (paragraph 13)

In order to plan the audit, the auditor should obtain a general understanding of the legal and regulatory framework applicable to the entity and the industry and how the entity is complying with that framework. (paragraph 15)

42. The legal and regulatory framework within which investment businesses conduct their business is summarised in the Introduction to the Practice Note. ISA (UK and Ireland) 250 Section A defines laws and regulations which are central to the entity's ability to conduct its business as those where either compliance is a prerequisite of obtaining a licence to operate or where non-compliance may reasonably be expected to result in the entity ceasing operations, or call into question the entity's status as a going concern.

After obtaining the general understanding, the auditor should perform further audit procedures to help identify instances of non-compliance with those laws and regulations where non-compliance should be considered when preparing financial statements, specifically:

- (a) Inquiring of management as to whether the entity is in compliance with such laws and regulations; and
- (b) Inspecting correspondence with the relevant licensing or regulatory authorities.

- (c) Enquiring of those charged with governance as to whether they are on notice of any such possible instances of non-compliance with law or regulations. (paragraph 18)

The auditor's procedures should be designed to help identify possible or actual instances of non-compliance with those laws and regulations which provide a legal framework within which the entity conducts its business and which are central to the entity's ability to conduct its business and hence to its financial statements. (paragraph 18-1)

43. In the context of investment businesses, the two criteria set out in paragraph 42 above indicate that laws and regulations are central to an investment business's ability to conduct its business if non-compliance could cause the regulator to revoke or restrict authorisation. In order to help identify possible or actual instances of non-compliance with laws and regulations which are central to an investment business's ability to conduct its business, specific areas that auditors' procedures may address include the following:
- obtaining a general understanding of the legal and regulatory framework applicable to the entity and industry, and of the procedures followed to ensure compliance with the framework;
 - reviewing the investment business's Scope of Part IV Permission (an FSA document which sets out the regulated activities that the firm is permitted to engage in, including any limitations and requirements imposed on those permitted activities);
 - reviewing correspondence with the FSA and other regulators (including that relating to any FSA supervisory visits, requests for information by the FSA or progress concerning FSA ARROW II risk mitigation programmes);
 - holding discussions with the investment business's compliance officer and other personnel responsible for compliance;
 - reviewing compliance reports prepared for the Board, audit committees and other committees; and
 - consideration of work on compliance matters carried out by internal audit.

The auditor should obtain sufficient appropriate audit evidence about compliance with those laws and regulations generally recognised by the auditor to have an effect on the determination of material amounts and disclosures in the financial statements. The auditor should have a sufficient understanding of these laws and regulations in order to consider them when auditing the assertions related to the determination of the amounts to be recorded and the disclosures to be made. (paragraph 19)

44. The auditor obtains sufficient audit evidence regarding compliance with those laws and regulations that can affect the material amounts and disclosures in the financial statements.
45. The auditor is alert to the fact that audit procedures applied for the purpose of forming an opinion on the financial statements may bring instances of possible non-compliance with the laws and regulations to the auditor's attention. For example, such audit procedures include reading minutes; inquiring of the entity's management and legal counsel concerning litigation, claims and assessments; and performing substantive tests of detail of classes of transactions, account balances or disclosures.
46. There are compensation schemes set up to protect individual investors for certain classes of business under the Financial Services Compensation Scheme (FSCS) (established under FSMA 2000). There are also consumer affairs bodies, such as the Financial Ombudsman Service (which handles consumer complaints) and the Office of Fair Trading (a statutory body which applies to both financial services and other retail organisations).
47. Investment businesses are affected by two types of regulation which are central to their activities and of which the auditor needs to obtain a general understanding:
 - (a) prudential rules; and
 - (b) conduct of business rules.

Prudential rules

48. The principal purpose of prudential supervision is to ensure the protection of clients because of the nature of transactions between investment businesses and the public. Much of the legislation for prudential supervision is based on European Directives. Prudential supervision of investment businesses is carried out by the FSA under rules made by the FSA under FSMA 2000. Ongoing prudential supervision of authorised investment businesses is conducted in part by means of annual regulatory returns submitted by many authorised investment businesses.
49. Examples of procedures which an auditor considers carrying out in connection with the prudential rules (which are also relevant to a consideration of going concern) during the course of his audit of the financial statements could include:
 - enquiring how management ensure that the financial resources calculations are properly prepared and submitted on time;
 - enquiring how management ensure that the firm complies with the financial resources requirements including, where relevant, at consolidated level and the large exposure rules;

- examining the returns to see whether they show that the firm/group has a reasonable surplus of regulatory capital. Enquiries should cover the accounting period being audited and the future period covered by the auditor's work on going concern;
- reviewing relevant correspondence with the FSA, for example waivers.

Conduct of Business Rules

50. Conduct of business regulation relates to the sale of business and is primarily carried out by the FSA through its rules in respect of COB (Conduct of Business rules).
51. The auditor has no direct reporting responsibility in respect of the conduct of business rules. However, breaches of such rules may:
- give rise to material fines and/or claims by investors against the investment business; and
 - cause the investment business to have its authorisation restricted or, in extreme cases, withdrawn, so threatening its viability as a going concern.
52. The auditor ensures that the staff involved in the audit have a general understanding of the business and the objectives of conduct of business regulation, sufficient to enable them to be alert to possible breaches which come to their attention.
53. As part of the normal procedures undertaken for the purposes of the audit of annual financial statements and reporting to the regulator, the auditor gains an understanding of the investment business's operations, including the nature of the investment business carried out.
54. The auditor also obtains an understanding of the control environment that exists, including the business's higher level procedures for complying with the conduct of business rules.
55. Such an understanding will provide an indication of the extent to which the general atmosphere and controls in the investment business are conducive to compliance, for example through consideration of:
- the adequacy of procedures and training to inform staff of the requirements of the rules of the regulator to ensure that they meet those requirements;
 - adequacy of authorities and supervision;
 - the review of compliance by senior management;
 - procedures to ensure that possible breaches are investigated by an appropriate person and are brought to the attention of senior management; and
 - the authority of, and resources available to, the Compliance Officer.

56. The auditor is alert to any indication that an investment business is conducting business outside the scope of its authorisation. Such action may be a serious regulatory breach, which may result in fines, suspension or loss of authorisation.
57. Where an apparent significant breach of the conduct of business rules comes to the auditors' attention, they ensure that its cause and implications for their reporting responsibilities are identified and further investigation may be appropriate.

Money laundering

In the UK and Ireland, when carrying out procedures for the purpose of forming an opinion on the financial statements, the auditor should be alert for those instances of possible or actual non compliance with laws and regulations that might incur obligations for partners and staff in audit firms to report money laundering offences. (paragraph 22-1)

58. Authorised firms including investment businesses are subject to the requirements of the Money Laundering Regulations 2007 and the Proceeds of Crime Act 2002 as well as FSA rules. These laws and regulations require institutions to establish and maintain procedures to identify their customers, establish appropriate reporting and investigation procedures for suspicious transactions and maintain appropriate records.
59. Laws and regulations relating to money laundering are integral to the legal and regulatory framework within which investment businesses conduct their business. By the nature of their business, investment businesses are ready targets of those engaged in money laundering activities.
60. The effect of this legislation is to make it an offence to provide assistance to those involved in money laundering and makes it an offence not to report suspicions of money laundering to the appropriate authorities, usually the Serious Organised Crime Agency (SOCA)¹². FSA requirements are set out in SYSC3.2.6AR – 6.3.5G¹³. In this context, FSA has due regard to compliance with the relevant provisions of guidance issued by the Joint Money Laundering Steering Group ('JMLSG')(SYSC3.2.6EG).
61. In addition to considering whether an investment business has complied with the money laundering laws and regulations, the auditor has reporting obligations under the Proceeds of Crime Act, 2002 and the Money Laundering Regulations, 2007 to report knowledge or suspicion of money laundering offences, including those arising from fraud and theft, to SOCA. The auditor is aware of the prohibition on 'tipping off' when

12 Previously National Criminal Intelligence Service ('NCIS').

13 For common platform firms the relevant references are included in SYSC 6.

discussing money laundering matters with the investment business.¹⁴ Further guidance for auditors is provided in PN 12 Money Laundering – Interim Guidance for Auditors in the United Kingdom (Revised).

62. The auditor, in the context of money laundering, is aware of the auditor's duty to report direct to the FSA in certain circumstances (see section relating to ISA (UK and Ireland) 250 Section B).

14 'Tipping off' is an offence for individuals in the regulated sector under POCA section 333A.

ISA (UK AND IRELAND) 250: SECTION B – THE AUDITOR’S RIGHT AND DUTY TO REPORT TO REGULATORS IN THE FINANCIAL SECTOR

The auditor of a regulated entity should bring information of which the auditor has become aware in the ordinary course of performing work undertaken to fulfil the auditor’s audit responsibilities to the attention of the appropriate regulator without delay when:

- (a) The auditor concludes that it is relevant to the regulator’s functions having regard to such matters as may be specified in statute or any related regulations; and
- (b) In the auditor’s opinion there is reasonable cause to believe it is or may be of material significance to the regulator. (paragraph 2)

Where an apparent breach of statutory or regulatory requirements comes to the auditor’s attention, the auditor should:

- (a) Obtain such evidence as is available to assess its implications for the auditor’s reporting responsibilities;
- (b) Determine whether, in the auditor’s opinion, there is reasonable cause to believe that the breach is of material significance to the regulator; and
- (c) Consider whether the apparent breach is criminal conduct that gives rise to criminal property and, as such, should be reported to the specified authorities. (paragraph 39)

Auditors’ duty to report to the FSA

63. Under the FSMA 2000 (Communication by Auditors) Regulations 2001 (the 2001 Regulations), auditors have duties in certain circumstances to make reports to the FSA. **The 2001 Regulations do not require auditors to perform any additional audit work as a result of the statutory duty nor are auditors required specifically to seek out breaches of the requirements applicable to a particular authorised person.** Information and opinions to be communicated are those meeting the criteria set out below which relate to matters of which the auditor¹⁵ of the authorised person (also referred to below as a ‘regulated entity’) has become aware:

15 An ‘auditor’ is defined for this purpose in the Regulations as a person who is, or has been, an auditor of an authorised person appointed under, or as a result of, a statutory provision including Section 340 of FSMA 2000.

- (i) in his capacity as auditor of the authorised person, and
 - (ii) if he is also the auditor of a person who has close links with the authorised person, in his capacity as auditor of that person.
64. The criteria for determining the matters to be reported are as follows:
- (i) the auditor reasonably believes that there is, or has been, or may be, or may have been a contravention of any 'relevant requirement' that applies to the person¹⁶ concerned and that contravention may be of material significance to the FSA in determining whether to exercise, in relation to that person, any of its functions under FSMA 2000, or
 - (ii) the auditor reasonably believes that the information on, or his opinion on, those matters may be of material significance to the FSA in determining whether the person concerned satisfies and will continue to satisfy the 'threshold conditions', or
 - (iii) the auditor reasonably believes that the person concerned is not, may not be, or may cease to be, a going concern, or
 - (iv) the auditor is precluded from stating in his report that the annual accounts have been properly prepared in accordance with the Companies Act 1985 or, where applicable, give a true and fair view or have been prepared in accordance with relevant rules and legislation¹⁷
65. In relation to 64 (i) above, 'relevant requirement' is a requirement by or under FSMA 2000 which relates to authorisation under FSMA 2000 or to the carrying on of any regulated activity. This includes not only relevant statutory instruments but also the FSA's rules (other than the Listing rules) including the principles for businesses¹⁸. The duty to report also covers any requirement imposed by or under any other Act¹⁹ the contravention of which constitutes an offence which the FSA has the power to prosecute under FSMA 2000.
66. In relation to 64 (ii) above the duty to report relates to either information or opinions held by the auditor which may be of significance to the FSA in determining whether the regulated entity satisfies and will continue to satisfy the 'Threshold Conditions'. The duty

16 In this context the person is an 'Authorised Person'.

17 Relevant rules and legislation comprise rules made by the FSA under Section 340 of FSMA 2000, and relevant provisions of, and regulations made under, the Building Societies Act 1986, the Friendly Societies Act 1992, or the Friendly and Industrial and Provident Societies Act 1968.

18 The status of the FSA's rules and principles for businesses is explained in Appendix 4 – The FSA Handbook.

19 Examples include Part 5 of the Criminal Justice Act 1993 and prescribed regulations relating to money laundering.

to report opinions, as well as information, allows for circumstances where adequate information on a matter may not readily be forthcoming from the regulated entity, and where judgments need to be made.

Material significance

67. Determining whether a contravention of a relevant requirement or a Threshold Condition is reportable under the 2001 Regulations involves consideration both of whether the auditor 'reasonably believes' and that the matter in question 'is, or is likely to be, of material significance' to the regulator.
68. The 2001 Regulations do not require auditors to perform any additional audit work as a result of the statutory duty nor are auditors required specifically to seek out breaches of the requirements applicable to a particular regulated entity. However, in circumstances where auditors identify that a reportable matter may exist, they carry out such extra work, as they consider necessary, to determine whether the facts and circumstances cause them 'reasonably to believe' that the matter does in fact exist. It should be noted that the auditors' work does not need to prove that the reportable matter exists.
69. ISA (UK and Ireland) 250 Section B requires that, where an apparent breach of statutory or regulatory requirements comes to the auditors' attention, they should obtain such evidence as is available to assess its implications for their reporting responsibilities and determine whether, in their opinion, there is reasonable cause to believe that the breach has occurred and that it relates to a matter that is of material significance to the regulator.
70. 'Material significance' is defined by paragraph 14 of ISA (UK and Ireland) 250 as follows:
- 'A matter or group of matters is normally of material significance to a regulator's function when, due either to its nature or its potential financial impact, it is likely of itself to require investigation by the regulator.'*
71. 'Material significance' does not have the same meaning as materiality in the context of the audit of financial statements. Whilst a particular event may be trivial in terms of its possible effect on the financial statements of an entity, it may be of a nature or type that is likely to change the perception of the regulator. For example, a failure to reconcile client money accounts may not be significant in financial terms but may have a significant effect on the FSA's consideration of whether the regulated entity was satisfactorily controlled and was behaving properly towards its customers.
72. The determination of whether a matter is, or is likely to be, of material significance to the FSA inevitably requires the auditor to exercise judgment. In forming such judgments, the auditor needs to consider not simply the facts of the matter but also their implications. In addition, it is possible that a matter, which is not materially significant in isolation, may become so when other possible breaches are considered.

73. The auditor of a regulated entity bases his judgment of 'material significance' to the FSA solely on his understanding of the facts of which he is aware without making any assumptions about the information available to the FSA in connection with any particular regulated entity.
74. Minor breaches of the FSA's rules that, for example, are unlikely to jeopardise the entity's assets or amount to misconduct or mismanagement would not normally be of 'material significance'. However, ISA (UK and Ireland) 250 requires auditors of regulated entities, when reporting on their financial statements, to review information obtained in the course of the audit and to assess whether the cumulative effect is of 'material significance' such as to give rise to a duty to report to the regulator. In circumstances where auditors are uncertain whether they may be required to make a report or not, they may wish to consider whether to take legal advice.
75. On completion of their investigations, the auditor ensures that the facts and circumstances, and the basis for his conclusion as to whether these are, or are likely to be of 'material significance' to the FSA, are adequately documented such that the reasons for his decision to report or not, as the case may be, may be clearly demonstrated.
76. Whilst confidentiality is an implied term of auditors' contracts with a regulated entity, section 342 of FSMA 2000 states that an auditor does not contravene that duty if he reports to the FSA information or his opinion, if he is acting in good faith and he reasonably believes that the information or opinion is relevant to any function of the FSA. The protection afforded is given in respect of information obtained in his capacity as auditor.

Conduct of the audit

77. ISA (UK and Ireland) 250 requires the auditor to ensure that all staff involved in the audit of a regulated entity 'have an understanding of:
- (a) the provisions of applicable legislation,
 - (b) the regulator's rules and any guidance issued by the regulator, and
 - (c) any specific requirements which apply to the particular regulated entity,
- appropriate to their role in the audit and sufficient (in the context of that role) to enable them to identify situations they encounter in the course of the audit which may give reasonable cause to believe that a matter should be reported to the regulator.'
78. Understanding, commensurate with the individual's role and responsibilities in the audit process, is required of :

- the provisions of the 2001 Regulations concerning the auditors' duty to report to the regulator,
- the Standards and guidance in ISA (UK and Ireland) 250, and in this section of this Practice Note, and
- relevant sections of the FSA's Handbook including the Principles for Businesses and the Threshold Conditions.

79. The auditor includes procedures within the planning process to ensure that members of the audit team have such understanding (in the context of their role) as to enable them to recognise potentially reportable matters, and that such matters are reported to the audit engagement partner without delay so that a decision may be made as to whether a duty to report arises.
80. An audit firm appointed as auditor of a regulated entity needs to have in place appropriate procedures to ensure that the audit engagement partner is made aware of any other relationship which exists between any department of the firm and the regulated entity when that relationship could affect the firm's work as auditor. (This matter is covered in more detail in Appendix 2 of ISA (UK and Ireland) 250). The auditor also requests the regulated entity to advise them when it appoints a third party (including another department or office of the same firm) to review, investigate or report on any aspects of its business activities that may be relevant to the audit of the financial statements and to provide the auditor with copies of reports by such a third party promptly after their receipt. This matter may usefully be referred to in the engagement letter.

Closely linked entities

81. Where the auditor of a regulated entity is also the auditor of a closely linked entity²⁰, a duty to report arises directly in relation to information relevant to the regulated entity of which he becomes aware in the course of his work as auditor of the closely linked entity.
82. The auditor establishes during audit planning whether the regulated entity has one or more closely linked entities of which the audit firm is also the auditor. If there are such entities the auditor considers the significance of the closely linked entities and the nature of the issues that might arise which may be of material significance to the regulator of the regulated entity. Such circumstances may involve:

20 An entity has close links with an authorised person for this purpose if the entity is a:

- (a) Parent undertaking of an authorised person;
- (b) Subsidiary undertaking of an authorised person;
- (c) Parent undertaking of a subsidiary undertaking of an authorised person; or
- (d) Subsidiary undertaking of a parent undertaking of an authorised person.

- activities or uncertainties within the closely linked entity which might significantly impair the financial position of the regulated entity,
 - money laundering and, if the closely linked entity is itself regulated,
 - matters that the auditor of the closely linked entity are intending to report to its regulator.
83. Following the risk assessment referred to in paragraph 82, the auditor of the regulated entity identifies the closely linked entities for which the procedures in this paragraph are necessary. The engagement team of the regulated entity communicates to the engagement team of the selected closely linked entities the audit firm's responsibilities to report to the FSA under the 2001 Regulations and notifies the engagement team of the circumstances that have been identified which, if they exist, might be of material significance to the FSA as regulator of the regulated entity. Prior to completion the auditor of the regulated entity obtains details from the auditor of the closely linked entity of such circumstances or confirmation, usually in writing, that such circumstances do not exist. Where the closely linked entities are part of the inter-auditor group reporting process these steps can be built into that process.
84. Whilst confidentiality is an implied term of auditors' contracts with a regulated entity, section 343 of FSMA 2000 states that an auditor of an entity closely linked to an authorised person who is also the auditor of that authorised person does not contravene that duty if he reports to the FSA information or his opinion, if he is acting in good faith and he reasonably believes that the information or opinion is relevant to any function of the FSA. The protection afforded is given in respect of information obtained in their capacity as the auditor.
85. No duty to report is imposed on the auditor of an entity closely linked to a regulated entity who is not also the auditor of the regulated entity.
86. In circumstances where they are not also the auditor of the closely linked entity, the auditor of the regulated entity decides whether there are any matters to be reported to the FSA relating to the affairs of the regulated entity in the light of the information that they receive about a closely linked entity for the purpose of auditing the financial statements of the regulated entity. If the auditor becomes aware of possible matters that may fall due to be reported, they may wish to obtain further information from the management or the auditor of the closely linked entity to ascertain whether the matter should be reported. To facilitate such possible discussions, at the planning stage of the audit, the auditor of the regulated entity will have considered whether arrangements need to be put in place to allow them to communicate with the management and the auditor of the closely linked entity. If the auditor of the regulated entity is unable to communicate with the management and the auditor of the closely linked entity to obtain further information concerning the matters they have identified they report the matters, and that they have been unable to obtain further information, direct to the FSA.

Information received in a capacity other than as auditor

87. There may be circumstances where it is not clear whether information about a regulated entity coming to the attention of the auditor is received in the capacity of auditor or in some other capacity, for example as a general adviser to the entity. Appendix 2 to ISA (UK and Ireland) 250 provides guidance as to how information obtained in non-audit work may be relevant to the auditor in the planning and conduct of the audit and the steps that need to be taken to ensure the communication of information that is relevant to the audit.

Discussing matters of material significance with the directors

88. The directors are the persons principally responsible for the management of the regulated entity. The auditor will therefore normally bring a matter of material significance to the attention of the directors and seek agreement on the facts and circumstances. However, ISA (UK and Ireland) 250 emphasises that where the auditor concludes that a duty to report arises they should bring the matter to the attention of the regulator without undue delay. The directors may wish to report the matters identified to the FSA themselves and detail the actions taken or to be taken. Whilst such a report from the directors may provide valuable information, it does not relieve the auditor of the statutory duty to report directly to the FSA.

Timing of a report

89. The duty to report arises once the auditor reasonably believes that the matter is or is likely to be of material significance to the FSA's regulatory function. In reaching a conclusion the auditor may wish to take appropriate legal or other advice and consult with colleagues.
90. The report should be made without undue delay once a conclusion has been reached. Unless the matter casts doubt on the integrity of the directors the matter can be discussed with the directors and further information sought as is necessary, so that a decision can be made on whether or not a duty to report exists. Such consultations and discussions are however undertaken on a timely basis to enable the auditor to conclude on the matter without undue delay.

Auditors' right to report to the FSA

91. Section 342 of FSMA 2000 provides that no duty to which an auditor of an authorised person is subject shall be contravened by communicating in good faith to the FSA information or an opinion on a matter that the auditor reasonably believes is relevant to any functions of the FSA.
92. The scope of the duty to report is wide particularly since, under the FSA's Principle for Businesses 11 (and corresponding application rules and guidance in SUP 15.3), an authorised firm must disclose to the FSA appropriately anything relating to the authorised firm of which the FSA would reasonably expect notice. However in circumstances where the auditor concludes that a matter does not give rise to a statutory duty to report but

nevertheless should be brought to the attention of the regulator, in the first instance they advise the directors of their opinion. Where the auditor is unable to obtain, within a reasonable period, adequate evidence that the directors have properly informed the FSA of the matter, then the auditor makes a report to the regulator without undue delay.

93. The auditor may wish to take legal advice before deciding whether, and in what form, to exercise their right to make a report direct to the regulator in order to ensure, for example, that only relevant information is disclosed and that the form and content of their report is such as to secure the protection of FSMA 2000. However, the auditor recognises that legal advice will take time and that speed of reporting is likely to be important in order to protect the interests of customers and/or to enable the FSA to meet its statutory objectives.

ISA (UK AND IRELAND) 300: PLANNING AN AUDIT OF FINANCIAL STATEMENTS

Background note

The purpose of this ISA (UK and Ireland) is to establish standards and provide guidance on the considerations and activities applicable to planning an audit of financial statements. This ISA (UK and Ireland) is framed in the context of recurring audits. In addition, matters the auditor considers in initial audit engagements are included in paragraphs 28 and 29.

The auditor should plan the audit so that the engagement will be performed in an effective manner (paragraph 2).

The auditor should establish the overall audit strategy for the audit (paragraph 8).

The auditor should develop an audit plan for the audit in order to reduce audit risk to an acceptably low level (paragraph 13).

94. To avoid potential duplication of audit effort, the audit approach to an investment business normally addresses the audit of the annual financial statements and the work required for the report to the FSA together.
95. Where applicable the auditor seeks to ensure that his audit work on the statutory accounts and the regulatory report is completed within timescales imposed by the FSA. The audit plan for an investment business typically explains the legal and regulatory background and, in order to reduce audit risk, discusses those areas where the auditor's responsibilities are different from those for other types of entity.
96. Matters the auditor of an investment business considers as part of the planning process for the audit of the financial statements include:
- the nature and scope of the investment business;
 - the investment business's relationships with the FSA and any other regulators;
 - changes in applicable laws, regulations and accounting requirements;
 - the need to involve specialists in the audit;
 - the extent to which controls and procedures are outsourced to a third-party provider; and

- issues relating to the auditor's statutory duty to report.
97. In general, further guidance on these matters is set out in the section on ISA (UK and Ireland) 315 'Obtaining an understanding of the entity and its environment and assessing the risks of material misstatement' below. Additional considerations in relation to the latter three matters in planning the audit could be:
- the nature and complexity of investment business increases the likelihood that the auditor may consider it necessary to involve specialists in the audit process. For example, the auditor may wish to utilise the work of an expert in the valuation of derivative and other financial instruments not traded in an active market. The auditor considers the need to involve such specialists at an early stage in planning his work. Where such specialists are to be used, they may be involved in the development of the audit plan and may take part in discussions with the management and staff, in order to assist in the development of knowledge and understanding relating to the business;
 - the auditor considers the implications of the outsourcing of functions by the investment business and the sources of evidence available to the auditor for transactions undertaken by service organisations in planning his work. This may include the outsourcing of certain functions, such as the IT functions. Further guidance is contained in the section of the Practice Note dealing with ISA (UK and Ireland) 402 'Audit Considerations Relating to Entities Using Service Organisations'; and
 - issues relating to the auditor's statutory duty to report include the adequacy of the audit team's understanding of relevant laws and regulations and the identification of closely linked entities.

ISA (UK AND IRELAND) 315: OBTAINING AN UNDERSTANDING OF THE ENTITY AND ITS ENVIRONMENT AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT

Background note

The purpose of this ISA (UK and Ireland) is to establish standards and to provide guidance on obtaining an understanding of the entity and its environment, including its internal control, and on assessing the risks of material misstatement in a financial statement audit.

98. Investment businesses can be complex and the auditor seeks to understand the business and the regulatory regime in which they operate. Generally, there is a close relationship between planning and obtaining an understanding of the business and the control environment, which is covered more fully below.

The auditor should obtain an understanding of relevant industry, regulatory, and other external factors including the applicable financial reporting framework (paragraph 22).

99. In obtaining an understanding of the regulatory factors the auditor considers:
- any formal communications between the FSA in its capacity as the regulator and the investment business, including any new or interim risk assessments issued by the FSA, the results of any other supervisory visits conducted by FSA, and any rule waivers granted or special conditions imposed;
 - the contents of any recent reports prepared by skilled persons under s166 FSMA 2000 together with any correspondence, minutes or notes of meetings relevant to any report;
 - any formal communications between the investment business and other regulators;
 - discussions with the investment business's compliance officer together with others responsible for monitoring regulatory compliance.
100. In addition in order to help identify the rules and regulations which are central to an investment business's ability to conduct its business, the auditor may:
- obtain a general understanding of the legal and regulatory framework applicable to the entity and industry, and of the procedures followed to ensure compliance with the framework; and

- review the firm's Scope of Permission Notice (this FSA document sets out the regulated activities that the firm is permitted to engage in, including any limitations and requirements imposed on those permitted activities), for example in relation to the holding of client assets and the extent of investment management discretion permitted.

101. For the audit of companies preparing financial statements under UK GAAP various Statements of Recommended Practice (SORPs) supplement the general accounting principles for particular types of investment business. FRS 18 – Accounting Policies requires that where a relevant SORP exists, financial statements state whether or not they have been prepared in accordance with the SORP, together with details of any departures from the recommended practice and disclosures.

The auditor should obtain an understanding of the nature of the entity (para 25).

102. As part of the normal procedures undertaken for the purposes of the audit of annual financial statements and reporting to the regulator, the auditor gains an understanding of the investment business's operations, including the nature of the business carried out.

103. When performing procedures to obtain an understanding of the investment business, the auditor considers:

- the relative importance to the investment business of each of its business activities. This includes an understanding of the type and extent of specialised activities;
- the introduction of new categories of customers, or products or marketing and distribution channels;
- the relevant aspects of the investment business's risk management procedures;
- the complexity of the investment business's information systems;
- the legal and operational structure of the investment business;
- a change in the market environment (for example, a marked increase in competition);
- the complexity of products;
- the consistency of products, methods and operations in different departments or locations;
- the respective roles and responsibilities attributed to the finance, risk control, compliance and internal audit functions.

104. Investment businesses can be involved in any of a wide range of market segments and products. The auditor identifies the principal income and expenditure categories, which could include:
- Fees and commissions receivable;
 - Commissions payable;
 - Trading of securities and other instruments and related gains and losses.
105. Some investment businesses operate a network of sales offices. In such instances, the auditor determines the degree of head office control over the business and accounting functions at the sales offices and the scope and effectiveness of the investment business's inspection and/or internal audit visits. The extent and impact of visits from regulators is also relevant. Where sales offices maintain separate accounting records, the extent of audit visits and work on each sales office is also dependent on the materiality of, and risks associated with, the operations of each sales office and the extent to which controls over sales offices are exercised centrally. In the case of smaller sales offices, the degree to which exceptions to an investment business's normal control procedures may be caused by minimal staffing levels (the greater difficulty of ensuring adequate segregation of duties, for example) and the consequent need for an increased level of control from outside the sales office are relevant to assessing audit risk.
106. Investment businesses, particularly in the retail sector, may use appointed representatives as a distribution channel for their products. Appointed representatives are not authorised in their own right and instead are the responsibility of the investment business. The auditor considers the increase in regulatory risk of monitoring and controlling appointed representatives in planning the audit approach.

The auditor should obtain an understanding of the entity's selection and application of accounting policies and consider whether they are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry (paragraph 28).

107. The auditor undertakes procedures to consider whether the policies adopted are in compliance with applicable accounting standards and gains an understanding of the procedures, systems and controls applied to maintain compliance with them. Accounting policies of particular relevance include those for revenue recognition, and the recognition of client assets. Areas that require careful attention are the extent to which income, and related costs, should be deferred and spread over a period or recognised 'up front', and whether client money and custody assets should be shown on the balance sheet of the statutory financial statements in cases where they meet the definition of assets as set out in the relevant accounting framework.

The auditor should obtain an understanding of the entity's objectives and strategies, and the related business risks that may result in material misstatement of the financial statements (paragraph 30).

108. The auditor seeks to identify the business risks that may have an impact on the financial statements. The auditor seeks to understand how these risks are managed and controlled by the investment business.
109. Depending on the business involved, the business risks the investment business is exposed to may include:
- *operational risk*: the risk of loss arising from inadequate or failed internal processes, people and systems or from external events, including legal risk;
 - *credit risk*: the risk that a counterparty will be unable to meet its obligations. One form of credit risk is default risk, which is the risk that a counterparty will be unable to settle its obligations under a transaction (in a securities settlement or payment system, for example) on the due date;
 - *market risk*: the risk that changes in the value of assets, liabilities and commitments will occur as a result of movements in relative prices (for example, as a result of changes in the market price of tradeable assets);
 - *regulatory risk*: the risk of public censure, fines (together with related compensation payments) and restriction or withdrawal of authorisation to conduct some or all of the investment business's activities. In the UK this may arise from enforcement activity by the FSA.
110. Failure to manage the risks outlined above can also cause serious damage to an investment business's reputation, potentially leading to loss of confidence in the business. (This is sometimes referred to as reputational risk or franchise risk).
111. Investment businesses should undertake appropriate risk assessment procedures as part of their risk management and internal control process under FSA rules. Investment businesses will normally be required to produce an internal capital adequacy assessment (ICAAP), which is designed to quantify risks specific to the entity and to generate and quantify an estimated capital requirement for the entity. The ICAAP includes an assessment of operational risk. Auditors will normally review such documentation in assessing the investment business's approach to addressing risks.
112. The auditor is alert to any indication that an investment business is conducting business outside the scope of its authorisation. Such action may be a serious regulatory breach, which may result in fines, suspension or loss of authorisation. In this respect the auditor

needs to be familiar with the list of activities of the investment business contained in the Scope of Permission Notice agreed with the FSA.

The auditor should obtain an understanding of the measurement and review of the entity's financial performance (paragraph 35).

113. The auditor obtains an understanding of the measures used by management to review the investment business's performance. This assists the auditor in understanding pressures on the firm that may prompt management to misstate the financial statements. This information may also assist the auditor when performing analytical procedures.
114. Key performance indicators will depend on the type and size of the investment business but may include the following:
- profitability ratios (net profit margin and return on equity);
 - expense ratios (particularly remuneration ratios as remuneration is usually the largest expense);
 - average commission per trade (for agency brokers); and
 - assets under management (for investment managers).

Small investment businesses are unlikely to have sophisticated performance review measures but will still rely on some key indicators.

115. The application of new and complex accounting standards such as IAS 32, IAS 39 and IFRS 7 (for investment businesses using EU IFRS) and FRSs 25, 26 and 29 (for investment businesses using UK GAAP) may also give rise to risks with respect to the recognition, classification and measurement of assets/liabilities, and over the adequacy of financial statement disclosure.

The auditor should obtain an understanding of the control environment (paragraph 67).

116. The quality of the overall control environment is dependent upon management's attitude towards the operation of controls. A positive attitude may be evidenced by an organisational framework which enables proper segregation of duties and delegation of control functions and which encourages failings to be reported and corrected. Thus, where a lapse in the operation of a control is treated as a matter of concern, the control environment will be stronger and will contribute to effective control systems; whereas a weak control environment will undermine detailed controls, however well designed.

117. In accordance with the requirements of SYSC and PRIN²¹ senior management has a responsibility for establishing and maintaining such systems and controls as are appropriate to the operations of an investment business. The FSA can hold senior managers personally accountable for an area or business for which they are responsible. This responsibility extends to personal behaviour not only by senior management but also to other Approved Persons²². Statements of Principle and Codes of Practice for Approved Persons include acting with integrity, due skill and care and diligence. The fit and proper test applied to Approved Persons includes competence and capability.
118. The FSA requires an investment business to maintain systems and controls appropriate for its business. These include (but are not limited to):
- clear and appropriate reporting lines which are communicated within the investment business;
 - appropriate controls to ensure compliance with laws and regulations (this may mean a separate compliance function);
 - appropriate risk assessment process;
 - appropriate management information;
 - controls to ensure suitability of staff;
 - controls to manage tensions arising out of remuneration policies;
 - documented and tested business continuity plans;
 - documented business plans or strategies (where appropriate);
 - an internal audit function (where appropriate);
 - an audit committee (where appropriate); and
 - appropriate record keeping arrangements.
119. For large investment businesses, the volume of transactions can be so great that it may be extremely difficult for the auditor to express an opinion without obtaining considerable assurance from adequate systems of control. Systems of internal control in an investment business are important in ensuring orderly and prudent operations of the investment business and in assisting the directors to prepare financial statements which give a true and fair view. The following features of the activities of investment businesses may be relevant to the auditor's assessment of such internal controls:

21 The Principles for Businesses sourcebook in the FSA Handbook.

22 Anyone performing a Controlled Function (an FSA defined term that includes roles beyond senior management such as the head of internal audit or the non-executive directors) must be approved by the FSA (an Approved Person).

- the substantial scale of transactions, both in terms of volume and relative value, makes it important that control systems are in place to ensure that transactions are recorded promptly, accurately and completely and are checked and approved, and that records are reconciled at appropriate intervals in order to identify and investigate differences promptly. Processing and accounting for complex transactions or high volumes of less complex transactions will almost inevitably involve the use of sophisticated technology. For example, transactions subject to 'straight through processing' involve little or no manual intervention after they have been initiated;
- the fact that investment businesses deal in money and near money instruments makes proper segregation of duties between and amongst those entering into transactions, those recording the transactions, those settling them and where relevant, those responsible for their physical security particularly important;
- the geographical or organisational dispersal of some investment business's operations means that, in order to maintain control over its activities, investment businesses need to ensure not only that there are sufficient controls at each location, but also that there are effective communication and control procedures between the various locations and the centre. It is important that there should be clear, comprehensive reporting and responsibility lines, particularly where the business is managed using a 'matrix' structure;
- the activities of investment businesses can typically result in the creation or use of derivatives and other complex transactions. The fact that the resultant cash flows may not take place for a considerable time creates the risk that wrongly recorded or unrecorded positions may exist and that these may not be detected for some time, thereby exposing the investment business to risk of misstatement. The valuation of these instruments also poses risks of misstatement. Consequently, investment businesses will normally have developed strong operational controls to mitigate such risks of misstatement; and
- the UK regulatory framework is both complex and evolving for investment businesses. This may give rise to significant liabilities for compensation to clients if not properly dealt with. Accordingly, an effective control system is essential to ensure that the requirements of the UK regulators are satisfied. Measures may also be needed to address regulators in other jurisdictions.

120. The auditor also obtains an understanding of the investment business's higher level procedures for complying with the rules governing, for example, client money and custody assets. Such an understanding will provide an indication of the extent to which the general atmosphere and controls in the investment business are conducive to compliance, for example through consideration of:

- the adequacy of procedures and training to inform staff of the requirements of the rules of the regulator to ensure that they meet those requirements;

- adequacy of authorities and supervision;
- the review of compliance by senior management;
- procedures to ensure that possible breaches are investigated by an appropriate person and are brought to the attention of senior management;
- the adequacy of procedures for addressing complaints made by customers in relation to information they were provided with at the time they made investments, which could lead to compensation becoming payable for whole classes of customers; and
- the authority of, and resources available to, the compliance officer.

121. The effective operation of a control system may be enhanced by an internal audit department or by specific monitoring performed by a compliance department. The existence of such departments and their scope and objectives are matters for management. In assessing the effectiveness of such departments, the auditor considers the terms of reference of the departments, their independence from operational personnel and management, the quality of staffing and to whom they report in the investment business.

The auditor should obtain a sufficient understanding of control activities to assess the risks of material misstatement at the assertion level and to design further audit procedures responsive to assessed risks (paragraph 90).

122. There is a wide variation between different investment businesses in terms of size, activity and organisation, so that there can be no standard approach to internal controls and risk. The auditor assesses the adequacy of controls in relation to the circumstances of each entity. Management of a small investment business may have less need to depend on formal controls for the reliability of the records and other information, because of personal contact with, or involvement in, the operation of the business itself.

123. Examples of weaknesses that may be relevant to the auditor's assessment of the risk of material misstatement are as follows:

- complex products or processes inadequately understood by management; this includes undue concentration of expertise concerning matters requiring the exercise of significant judgment or capable of manipulation such as valuations of financial instruments or allowances for impairment;
- weaknesses in back office procedures contributing to completeness and accuracy of accounting records such as:

- backlogs in key reconciliations, particularly those over bank accounts, settlement accounts and the custody of assets such as securities (either those held on own account or as collateral);
 - inadequate maintenance of suspense or clearing accounts; and
 - backlogs in confirmation processes relating to financial instrument transactions.
- weaknesses in new product approval procedures; and
 - lack of segregation of duties such as between dealing, operational, control, settlement and accounting functions.

124. The auditor may assess and test different systems and controls in different investment businesses, if the auditor considers they provide reasonable assurance that certain control objectives have been achieved. In designing the systems and controls, management should address the following general control objectives:

- (a) the business is planned and conducted in an orderly, prudent and cost-effective manner in adherence to established and documented policies;
- (b) transactions and commitments are entered into only in accordance with management's general or specific authority;
- (c) client assets are safeguarded and are completely and accurately recorded;
- (d) the assets of the business are safeguarded and the liabilities controlled;
- (e) the risk of loss from fraud, other irregularities and error is minimised, and any such losses are promptly and readily identified;
- (f) management is able to monitor on a regular and timely basis the investment business's position relative to its risk exposure;
- (g) management is able to prepare complete and accurate returns for the regulator on a timely basis in accordance with the rules; and
- (h) issues relating to compliance with the rules are resolved in a timely manner to the satisfaction of the FSA.

125. Systems and controls, including the assignment of responsibilities, should be clearly documented if they are to be understood, communicated and operated effectively and consistently. The investment business and its auditor consider appropriate documentation a prerequisite of an adequate system.

126. Where an investment business provides safeguarding and administration of assets and/or holds client money, the auditor's understanding of the relevant internal controls is particularly important due to the potential exposure of the investment business to claims for compensation, and the requirement for the auditor to report on operational controls relating to client assets.

127. Controls relating to outsourcing activities are considered in the ISA (UK and Ireland) 402 section.

The auditor should obtain an understanding of how the entity has responded to risks arising from IT. (paragraph 93).

128. Investment businesses rely heavily on information technology to process trades, obtain market data, manage client data etc. Failures in hardware and software can disrupt operations and lead to loss for the investment business. Investment businesses that provide on-line trading facilities have an even greater risk of loss in event of failure. Investment businesses may also rely heavily on spreadsheets for risk modelling, valuation, and profit and loss calculations.

129. The auditor assesses the extent, nature and impact of automation within the investment business and plans and performs work accordingly. In particular the auditor considers:

- the required level of IT knowledge and skills may be extensive and may require the auditor to obtain advice and assistance from staff with specialist skills;
- the extent of the application of audit software and related audit techniques;
- general controls relating to the environment within which IT based systems are developed, maintained and operated;
- external interfaces susceptible to breaches of security.

130. A single computer system rarely covers all of the investment business's requirements. It is common for investment businesses to employ a number of different systems and, in many cases, use PC-based applications (sometimes involving the use of complex spreadsheets) to generate important accounting and/or internal control information. The auditor identifies and understands the communication between computer systems in order to assess whether appropriate controls are established and maintained to cover all critical systems and the links between them and to identify the most effective audit approach.

The auditor should identify and assess the risks of material misstatement at the financial statement level, and at the assertion level for classes of transactions, account balances, and disclosures (paragraph 100).

As part of the risk assessment, the auditor should determine which of the risks identified are, in the auditor's judgment, risks that require special audit consideration (such risks are defined as 'significant risks') (paragraph 108).

For significant risks, to the extent the auditor has not already done so, the auditor should evaluate the design of the entity's related controls, including relevant control activities, and determine whether they have been implemented. (paragraph 113).

131. Set out below are certain risks that the auditor may determine to be significant. This list is not all encompassing and will vary for each type of investment business:

- the valuation of investments, including derivatives, which could have a significant impact on the financial statements;
- breaches of the regulator's requirements including, but not limited to, the maintenance of adequate financial resources, controls over client money and assets and anti-money-laundering procedures. This could lead to claims from customers, fines imposed by the FSA and, in severe cases, the investment business may risk losing its authorisation;
- breaches of the terms of client mandates could lead to claims from customers and regulatory fines; and
- the calculation of performance fees to be paid by clients.

ISA (UK AND IRELAND) 320: AUDIT MATERIALITY

Background note

The purpose of this ISA (UK and Ireland) is to establish standards and provide guidance on the concept of materiality and its relationship with audit risk.

The auditor should consider materiality and its relationship with audit risk when conducting an audit (paragraph 2).

Materiality should be considered by the auditor when:

- (a) Determining the nature, timing and extent of audit procedures; and
- (b) Evaluating the effect of misstatements (paragraph 8).

132. The principles of assessing materiality in the audit of an investment business are the same as those applying to the audit of any other entity. In particular the auditor's consideration of materiality is a matter of professional judgment, and is affected by the auditor's perception of the common information needs of users as a group²³.
133. Most investment businesses are profit orientated and a profit based measure, such as a percentage of profit before tax or income is likely to be used. However it is not uncommon in investment businesses to encounter balance sheet misclassifications that do not affect profit. It may be appropriate when scoping audit work specifically addressing the risk of balance sheet only errors, or where such errors are discovered, to use higher materiality thresholds.

23 The International Accounting Standards Board's 'Framework for the Preparation and Presentation of Financial Statements' indicates that, for a profit orientated entity, as investors are providers of risk capital to the enterprise, the provision of financial statements that meets their needs will also meet most of the needs of other users that financial statements can satisfy.

ISA (UK AND IRELAND) 330: THE AUDITOR'S PROCEDURES IN RESPONSE TO ASSESSED RISKS

Background note

The purpose of this ISA (UK and Ireland) is to establish standards and provide guidance on determining overall responses and designing and performing further audit procedures to respond to the assessed risks of material misstatement at the financial statement and assertion levels in a financial statement audit.

When, in accordance with paragraph 115 of ISA (UK and Ireland) 315 the auditor has determined that it is not possible or practicable to reduce the risks of material misstatement at the assertion level to an acceptably low level with audit evidence obtained only from substantive procedures, the auditor should perform tests of relevant controls to obtain audit evidence about their operating effectiveness (paragraph 25).

134. Investment businesses that deal on their own account may hold positions in investments at the year-end. Investments held may be valued at fair value, in order to derive the gains or losses related to holding the positions during the financial year and to reflect their current value in the balance sheet. Where an investment business has extensive holdings, a wholly substantive approach to auditing their values may not be practicable. In those circumstances, the auditor may wish to perform tests of controls over the valuation methods used within the product control function.
135. Investment businesses that earn fees for conducting business on behalf of clients may be fined if they breach FSA rules. They may also be liable to pay compensation to clients for instances of breach of contract or mandate or for dealing errors. It is possible that at the year-end there are breaches that are not provided for, either unidentified or fraudulently suppressed. The auditor uses substantive procedures, for example examination of breaches and complaints registers, inquiry of relevant employees and officers and review of correspondence to identify liabilities for breaches and errors. The auditor also assesses the likelihood of unidentified material breaches and errors by understanding the procedures for monitoring the conduct of the business and for identifying breaches and errors. The auditor may determine that it is appropriate to review the controls performed by compliance personnel, the functions performed by the Money Laundering Reporting Officer, the procedures intended to ensure compliance with the client money and client assets rules, and the procedures associated with the breaches register.

Irrespective of the assessed risk of material misstatement, the auditor should design and perform substantive procedures for each material class of transactions, account balance, and disclosure (paragraph 49).

136. The conduct of investment business generates cash movement. As a result, audit procedures based on following up differences identified in bank reconciliations, and on items posted to any related suspense accounts, will provide substantive evidence for many assertions associated with the significant classes of transactions. Further evidence may be required for the completeness of expenses and associated liabilities, the validity of income and associated assets, and for whether the non-cash side of the double entry has been posted to the correct account. Additional substantive procedures that the auditor may perform for the significant classes of income and expense transactions identified above may include:

Fees and commissions receivable

- analytical procedures that relate fees and commissions received to the number or value of agency transactions or to the value of funds under management, depending on the basis for their calculation;
- tests of details involving recalculation of performance fees, normal fees and commissions actually charged, and that should have been charged, according to the underlying agreements;
- where there are material amounts receivable at the year-end, analytical procedures and tests of details may be performed on those items, including an assessment of the recoverability of the outstanding amounts.

Commissions payable

- analytical procedures that relate commissions paid to the transactions on which they are based depending on the calculation basis;
- tests of details involving recalculation of commissions paid in accordance with the underlying agreements;
- where there are material amounts payable at the year-end, analytical procedures and tests of detail may be performed specifically on those items;
- tests of the completeness of year-end accruals by reference to the underlying agreements.

Trading of securities and other instruments and related gains and losses.

137. Gains and losses result when securities are traded. Although both cash and securities move when security trades are settled, this movement is normally electronic rather than physical, and settlement success or failure, together with any settlement differences, are

reported to the parties concerned. Substantive procedures may include tests of detail based on these reports, in addition to bank reconciliation procedures on the accounts that include securities transactions.

138. Where securities have been traded before the year-end with settlement due after the year-end, tests of details on the security positions and the counterparty balances may be based on reports of the subsequent settlement (or settlement failure).
139. The accuracy of the firm's record of investments held at year-end is normally audited based on tests of the reconciliation ('depot reconciliation') between the firm's records of positions and the details supplied by the custodian. For financial instruments traded 'over the counter' audit procedures may compare records with the underlying contracts.
140. Holding gains and losses result when year-end positions in financial instruments are revalued. Substantive procedures related to the valuation used, and hence the gains and losses themselves, are considered below.

When the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor should perform substantive procedures that are specifically responsive to that risk (paragraph 51).

141. For investment businesses, significant risks may include the valuation of investments held, and liabilities for breach of regulations and for breaches of contract or mandate and the calculation of performance fees. These matters are considered below.

Valuation of investments

142. Year-end positions in investments including any derivatives may be valued by being 'marked to market' or at fair value.
143. The prices of frequently traded instruments dealt on a recognised exchange can be identified from authoritative sources and little or no judgment is necessary in valuing these investments. Some unquoted securities may be equated to a closely equivalent quoted security and priced accordingly, in which case the auditor considers whether the identified equivalent is appropriate, whether any adjustments need to be made, and whether those made are appropriate.
144. Other instruments without a readily ascertainable market value may be priced by complex models – 'marked to model'. This may involve significant judgment in the choice or development of the models and in the assumptions used. Further guidance on valuations is set out in the section on ISA (UK and Ireland) 540.

Liabilities for breaches

145. The auditor may ask for information from the investment business's legal advisors, may inspect correspondence from clients for complaints, and may decide to review the investment business's records to check for compliance with some regulatory requirements. However, there are no substantive procedures that can conclusively identify breaches that the investment business has not itself identified. In the absence of fraudulent collusion, the auditor may rely on consistency of information and explanations between those responsible for the management of operations, the compliance function, and the finance function. The auditor obtains a representation from the management of the investment business on whether they are aware of any actual or potential non-compliance with laws and regulations that could have a material effect on the ability of the investment business to conduct its business and therefore on the results and financial position to be disclosed in the financial statements.
146. Although custody assets and client money are often not part of the audited financial statements, any material deficiency in client assets could have a direct impact on the financial position of the investment business, either because of compensation due to the customer or perhaps regulatory fines. Guidance on the work the auditor needs to perform when reporting to the FSA under SUP 3.10 in the area of client money and custody assets is given in the section on Auditors' report to the FSA and in appendix 2 to this Practice Note. Investment businesses often account for compensation to clients on a cash basis because of the individually small amounts involved. However, material compensation outstanding at the year-end should be provided for in the financial statements. Consideration will also be given to whether these circumstances may also attract a fine for breach of the FSA rules.

Performance fees

147. Performance fees may represent a significant risk for an investment business. The auditor obtains an understanding of the investment business's systems and controls over performance fees. The auditor may also carry out tests of detail on performance fees including:
- confirming the basis of the performance fee calculation to the underlying agreement;
 - agreeing that figures used in the performance fee calculation have been correctly extracted from the underlying records;
 - reviewing the reasonableness of any estimates or underlying assumptions;
 - recalculating the performance fees.

Consideration may also be given to any sources of third party information which is available to support the basis of the performance fee calculation.

The auditor should perform audit procedures to evaluate whether the overall presentation of the financial statements, including the related disclosures, are in accordance with the applicable financial reporting framework. (paragraph 65)

148. Specific financial reporting standards can require extensive narrative disclosures in the financial statements of investment businesses; for example, in relation to the nature and extent of risks arising from financial instruments. In this respect IFRS 7 and FRS 29 are particularly relevant. In designing and performing procedures to evaluate these disclosures the auditor obtains audit evidence regarding the assertions about presentation and disclosure described in paragraph 17 of ISA (UK and Ireland) 500: Audit Evidence. In the specific case of market risk information the auditor refers to the section on ISA (UK and Ireland) 330 in Practice Note 19 'The audit of banks and building societies in the United Kingdom (Revised)'.

ISA (UK AND IRELAND) 402: AUDIT CONSIDERATIONS RELATING TO ENTITIES USING SERVICE ORGANISATIONS

Background note

The purpose of this ISA (UK and Ireland) is to establish standards and provide guidance to an auditor where the entity uses a service organisation.

In obtaining an understanding of the entity and its environment, the auditor should determine the significance of service organization activities to the entity and the relevance to the audit (paragraph 5).

149. In common with other industries the outsourcing of functions to third parties is becoming increasingly prevalent with investment businesses. Some of the more common areas, such as property management, may have no direct impact on the audit, while others such as IT functions may have a direct relevance. The auditor therefore gains an understanding of the extent of outsourced functions and their relevance to the financial statements. The investment business is obliged to ensure that the auditor has appropriate access to records, information and explanations from material outsourced operations.
150. The auditor considers the nature of services provided by the service organisation, contractual terms and the components of the entity's internal control which are relevant to the service organisation. The auditor documents and understands the contractual terms with the service organisation. In doing this the auditor may consider the information to be provided to the entity, the maintenance of the accounting records, the entity's and external auditor's rights of access to the accounting records and whether the terms take account of relevant requirements of regulatory bodies.
151. Investment businesses commonly outsource a variety of activities. Specific examples, which are relevant activities, include:
- safe custody of investments by a custodian;
 - settlement or clearing of trades;
 - maintenance of accounting records;
 - transfer agency;
 - product administration;
 - investment management.

Based on the auditor's understanding of the aspects of the entity's accounting system and control environment relating to relevant activities, the auditor should:

- (a) Assess whether sufficient appropriate audit evidence concerning the relevant financial statement assertions is available from records held at the entity; and if not,
- (b) Determine effective procedures to obtain evidence necessary for the audit, either by direct access to records kept by service organisations or through information obtained from the service organisations or their auditor (paragraph 9-18).

If an auditor concludes that evidence from records held by a service organisation is necessary in order to form an opinion on the client's financial statements and the auditor is unable to obtain such evidence, the auditor should include a description of the factors leading to the lack of evidence in the basis of opinion section of their report and qualify their opinion or issue a disclaimer of opinion on the financial statements (paragraph 18-1).

152. Whilst an investment business may outsource functions to third parties the responsibility of these functions remains that of the investment business. The investment business should have appropriate controls in place over these arrangements which may include:

- risk assessment prior to contracting with the service provider, which includes a proper due diligence and periodic review of the appropriateness of the arrangement;
- appropriate contractual agreements or service level agreements;
- contingency plans should the provider fail in delivery of services;
- appropriate management information and reporting from the outsourced provider;
- appropriate controls over customer information; and
- right of access of the investment business's internal auditor to test the internal controls of the service provider.

153. If the auditor is unable to obtain sufficient audit evidence concerning outsourced operations the auditor considers whether it is necessary to report the matter direct to the FSA – see guidance in the section on ISA (UK and Ireland) 250 Section B.

ISA (UK AND IRELAND) 505: EXTERNAL CONFIRMATIONS

Background note

The purpose of this ISA (UK and Ireland) is to establish standards and provide guidance on the auditor's use of external confirmations as a means of obtaining audit evidence.

The auditor should determine whether the use of external confirmations is necessary to obtain sufficient appropriate audit evidence at the assertion level. In making this determination, the auditor should consider the assessed risk of material misstatement at the assertion level and how the audit evidence from other planned audit procedures will reduce the risk of material misstatement at the assertion level to an acceptably low level (paragraph 2).

154. Whilst audit evidence is more reliable when obtained directly from a third party the auditor considers whether evidence obtained from other procedures provides sufficient appropriate audit evidence. For investment management fee debtors and settlement balances, given that the balances are normally only outstanding for a very short period of time the testing of invoicing and settlement controls together with substantive testing of after date cash receipts and payments may provide sufficient appropriate audit evidence.

ISA (UK AND IRELAND) 520: ANALYTICAL PROCEDURES

Background note

The purpose of this ISA (UK and Ireland) is to establish standards and provide guidance on the application of analytical procedures during an audit.

The auditor should apply analytical procedures as risk assessment procedures to obtain an understanding of the entity and its environment and in the overall review at the end of the audit (paragraph 2).

155. Relationships between certain financial and non-financial data can be compared to a prior period, auditor expectations and industry averages. Analytical procedures for investment businesses may include, for example, comparison of:
- fees to funds under management and market indices, and
 - commission income and expense to transaction volumes.
156. The use of analytical procedures at the planning stage may highlight events or aspects of the clients' business of which the auditor was previously unaware. These procedures will generally be based upon management accounts and other interim financial and non-financial information available. In determining the audit approach the auditor may apply substantive analytical procedures as part of the overall approach. These procedures will generally be more appropriate when there are larger volumes of transactions which tend to be more predictable.
157. In performing analytical procedures the auditor develops an expectation for the account being reviewed. This expectation will be based on the financial and non-financial data being used and the auditor considers whether the accuracy and reliability of the data can provide the desired level of assurance. The auditor determines the amount of the difference from expectation which requires no further investigation in accordance with the assessed materiality.
158. The auditor applies analytical procedures to the overall review of the financial statements towards the end of the audit process. This will support the overall conclusion on the financial statements.
159. Where non financial information or reports produced from systems or processes outside the financial statements accounting system are used in analytical procedures, the auditor considers the reliability of that information or those reports.

ISA (UK AND IRELAND) 540: AUDIT OF ACCOUNTING ESTIMATES

Background note

The purpose of this ISA (UK and Ireland) is to establish standards and provide guidance on the audit of accounting estimates contained within the financial statements.

The auditor should obtain sufficient appropriate audit evidence regarding accounting estimates (paragraph 2)

The auditor should adopt one or a combination of the following approaches in the audit of an accounting estimate:

- (a) Review and test the process used by management to develop the estimate;
- (b) Use an independent estimate for comparison with that prepared by management;
or
- (c) Review subsequent events which provide audit evidence of the reasonableness of the estimate made (paragraph 10).

The auditor should make a final assessment of the reasonableness of the entity's accounting estimates based on the auditor's understanding of the entity and its environment and whether the estimates are consistent with other audit evidence obtained during the audit (paragraph 24).

160. Accounting estimates are used for valuation purposes in some investment businesses, for example, over-the-counter derivatives and illiquid trading positions. For various derivative instruments the auditor may not be able readily to substantiate an independent fair market valuation. In these instances the business may arrange for some form of mathematical modelling to be undertaken to provide a valuation for review and testing by the auditor. The auditor reviews the process for developing and testing the model which has been used by the investment business, and in particular the performance of the model in various conditions when compared with prices actually obtained in the market. This involves obtaining an understanding of the assumptions and a review of the estimates involved for reasonableness, consistency and conformity with generally accepted practices. Given the special complexities involved with these types of products it is common practice for a specialist in this area to be involved in the work.

161. Accounting estimates might also be required in connection with, for example, establishing liabilities for compensation payable to clients as a result of fund pricing errors, and for investment management fee repayments where performance fee arrangements provide for potential clawback.
162. Based on the audit evidence obtained, the auditor may conclude that the evidence points to an estimate that differs from management's estimate, and that the difference between the auditor's estimate or range and management's estimate constitutes a financial statement misstatement. In such cases, where the auditor has developed a range, a misstatement exists when management's estimate lies outside the auditor's range. The misstatement is measured as the difference between management's estimate and the nearest point of the auditor's range.
163. Management bias, whether unintentional or intentional, can be difficult to detect in a particular estimate. It may only be identified when there has been a change in the method for calculating estimates from the prior period based on a subjective assessment without evidence that there has been a change in circumstances, when considered in the aggregate of groups of estimates or all estimates, or when observed over a number of accounting periods. Although some form of management bias is inherent in subjective decisions, management may have no intention of misleading the users of financial statements. If, however, there is intention to mislead through, for example, the intentional use of unreasonable estimates, management bias is fraudulent in nature. ISA 240, 'The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements,' provides standards and guidance on the auditor's responsibility to consider fraud in an audit of financial statements.

ISA (UK AND IRELAND) 545: AUDITING FAIR VALUE MEASUREMENTS AND DISCLOSURES

Background note

The purpose of this ISA (UK and Ireland) is to establish standards and provide guidance on auditing fair value measurements and disclosures contained in financial statements.

The auditor should obtain sufficient appropriate audit evidence that fair value measurements and disclosures are in accordance with the entity's applicable financial reporting framework (paragraph 3).

As part of the understanding of the entity and its environment, including its internal control, the auditor should obtain an understanding of the entity's process for determining fair value measurements and disclosures and of the relevant control activities sufficient to identify and assess the risks of material misstatement at the assertion level and to design and perform further audit procedures (paragraph 10).

The auditor should evaluate whether the fair value measurements and disclosures in the financial statements are in accordance with the entity's applicable financial reporting framework (paragraph 17).

164. The valuation of derivative and other financial instruments which are not traded in an active market and so for which valuation techniques are required is an activity that can give rise to significant audit risk. Such financial instruments are priced using valuation techniques such as discounted cashflow models, options pricing models or by reference to another instrument that is substantially the same as the financial instrument subject to valuation. The auditor reviews the controls, procedures and testing of the valuation techniques used by the investment business. Controls and substantive testing could include focussing on:

- valuation technique approval and testing procedures used by the investment business;
- the independence of review, sourcing and reasonableness of observable market data and other parameters used in the valuation techniques;
- calibration procedures used by the investment business to test the validity of valuation techniques applied by comparing outputs to observable market transactions;

- the extent and quality of sensitivity analyses prepared by management in relation to both market observable data and other assumptions built into the valuations;
- completeness and appropriate inclusion of all relevant observable market data;
- the observability in practice of data classified by the investment business as observable market data;
- the appropriateness and validity of classification of instruments designated as being traded in a non active and in an active market;
- the appropriateness and validity of the particular valuation technique applied to particular financial instruments;
- the appropriateness and validity of the parameters used by the investment business to designate an instrument as substantially the same as the financial instrument being valued;
- mathematical integrity of the valuation model; and
- access controls over valuation models.

165. In the more subjective areas of valuation the auditor obtains an understanding of the assumptions used and undertakes a review of the estimates involved for reasonableness, consistency and conformity with generally accepted practices. In some cases, the auditor may use his own valuation techniques to assess the investment business's valuations. Given the complexities involved and the subjective nature of the judgments inherent the auditor may involve an expert in elements of this work (see the ISA (UK and Ireland) 620 section of this Practice Note).

ISA (UK AND IRELAND) 550: RELATED PARTIES

Background note

The purpose of this ISA (UK and Ireland) is to establish standards and provide guidance on the auditor's responsibilities and audit procedures regarding related parties and transactions with such parties regardless of whether International Accounting Standard (IAS) 24, 'Related Party Disclosures,' or similar requirement, is part of the applicable financial reporting framework.

When planning the audit the auditor should assess the risk that material undisclosed related party transactions, or undisclosed outstanding balances between an entity and its related parties may exist. (paragraph 106-3)

166. Related party transactions are defined in FRS 8/IAS 24 'Related party disclosures'. Paragraph 16 of FRS 8 states that the 'disclosure provisions do not apply where to comply with them conflicts with the reporting entity's duties of confidentiality arising by operation of law'. IAS 24 contains no explicit corresponding exemption. However the potentially overriding impact of law concerning confidentiality in respect of disclosures under IAS 24 still needs to be considered.
167. Both when applying IFRS or UK GAAP, under ISA (UK and Ireland) 550, the auditor is required to assess the risk that material undisclosed related party transactions may exist. It is in the nature of investment business that transaction volumes are high but this factor will not, of itself, necessarily lead the auditor to conclude that the inherent risk of material undisclosed related party transactions is high.
168. Investment businesses are required to report to FSA changes in control (in some instances with FSA prior approval), changes in circumstances of existing controllers and changes in entities who are closely linked to the firm (SUP 11). In addition, there are annual reporting obligations in respect of controllers and entities who are closely linked to the firm (SUP 16). As a result, it will therefore normally be the case that there are controls in place to ensure that this information is properly collated. However, the definition of "controller" and "closely linked" for regulatory purposes is not congruent with the 'related party' definition in FRS 8/IAS 24 and the auditor therefore considers what controls have been put in place by management to capture information on those parties which fall within the accounting definition only.
169. In reviewing related party information for completeness, the auditor may compare the proposed disclosures in the financial statements to information prepared for regulatory reporting purposes (bearing in mind that the population may be different, as noted in the preceding paragraph).

ISA (UK AND IRELAND) 560: SUBSEQUENT EVENTS

Background note

The purpose of this ISA (UK and Ireland) is to establish standards and provide guidance on the auditor's responsibility regarding subsequent events.

The auditor should perform audit procedures designed to obtain sufficient appropriate audit evidence that all events up to the date of the auditor's report that may require adjustment of, or disclosure in, the financial statements have been identified (paragraph 4).

170. In addition to the specific procedures outlined in ISA (UK and Ireland) 560 to identify subsequent events which may require amendment to, or disclosure in the financial statements of an investment business, the auditor reviews correspondence with the FSA and makes enquiries of management to determine whether any breaches of regulations or other regulatory concerns have come to their attention since the period end.

ISA (UK AND IRELAND) 570: THE GOING CONCERN BASIS IN FINANCIAL STATEMENTS

Background note

The purpose of this ISA (UK and Ireland) is to establish standards and provide guidance on the auditor's responsibility on the audit of financial statements with respect to the going concern assumption used in the preparation of the financial statements, including management's assessment of the entity's ability to continue as a going concern.

When planning and performing audit procedures and in evaluating the results thereof, the auditor should consider the appropriateness of management's²⁴ use of the going concern assumption in the preparation of the financial statements (paragraph 2).

The auditor should consider any relevant disclosures in the financial statements (paragraph 2-1).

In obtaining an understanding of the entity, the auditor should consider whether there are events or conditions and related business risks which may cast significant doubt on the entity's ability to continue as a going concern (paragraph 11).

171. In reviewing going concern, the auditor of an investment business considers the following areas in addition to those set out in ISA (UK and Ireland) 570, since the attitude of the FSA and the continued authorisation of the business is particularly relevant to the going concern assumption:

- regulatory censure or fines;
- regulatory capital deficits (as at reporting date and forecast for an appropriate period) (see also paragraph 49);
- reputational and other indicators;
- general non-compliance with the rules of the FSA.

172. If the auditor has any doubts as to the ability of an investment business to continue as a going concern, the auditor considers whether he ought to make a report direct to the FSA on which guidance is set out in the section of this Practice Note relating to ISA (UK and Ireland) 250 Section B.

24 In the UK and Ireland, those charged with governance are responsible for the preparation of the financial statements and the assessment of the entity's ability to continue as a going concern.

ISA (UK AND IRELAND) 580: MANAGEMENT REPRESENTATIONS

Background note

The purpose of this ISA (UK and Ireland) is to establish standards and provide guidance on the use of management representations as audit evidence, the procedures to be applied in evaluating and documenting management representations and the action to be taken if management refuses to provide appropriate representations.

Written confirmation of appropriate representations from management should be obtained before the audit report is issued (paragraph 2-1).

The auditor should obtain written representations from management on matters material to the financial statements when other sufficient appropriate audit evidence cannot reasonably be expected to exist (paragraph 4).

173. ISA (UK and Ireland) 580 requires the auditor to obtain written confirmation of appropriate representations from management. These may take a form of a Board meeting minute or a representation letter and normally include a representation concerning the completeness of information made available to the auditor, including correspondence with regulators. In addition, ISAs (UK and Ireland) 250 Section A and 550 require the auditor to obtain written confirmation in respect of completeness of disclosure to the auditor of:

- all known actual or possible non-compliance with laws and regulations (including breaches of FSMA 2000, FSA rules, the Money Laundering Regulations, other regulatory requirements or any other circumstance that could jeopardise the authorisation of the firm under FSMA 2000) whose effects should be considered when preparing financial statements together with the actual or contingent consequences which may arise therefrom; and
- the completeness of information provided regarding the identification of related parties and the adequacy of related party disclosures in the financial statements.

174. In addition to the examples of other representations given in ISA (UK and Ireland) 580 the auditor of an investment business also considers obtaining additional confirmations. The letter could cover the following representations:

- acknowledging management's responsibility for establishing and maintaining accounting records and systems of control in accordance with the rules of the

regulator and confirming that unadjusted misstatements are immaterial, both individually and in aggregate;

- confirming that management has made available to the auditor all correspondence and notes of meetings with the FSA relevant to the auditor's examination;
- that all complaints have been drawn to the attention of the auditor;
- where applicable, a representation that no client money or custody assets were administered or held by the investment business;
- that where applicable consolidated supervision does not apply.

ISA (UK AND IRELAND) 600: USING THE WORK OF ANOTHER AUDITOR**Background note**

The purpose of this ISA (UK and Ireland) is to establish standards and provide guidance when an auditor, reporting on the financial statements of an entity, uses the work of another auditor on the financial information of one or more components included in the financial statements of the entity. This ISA (UK and Ireland) does not deal with those instances where two or more auditors are appointed as joint auditors nor does it deal with the auditors' relationship with a predecessor auditor. Further, when the principal auditor concludes that the financial statements of a component are immaterial, the standards in this ISA (UK and Ireland) do not apply. When, however, several components, immaterial in themselves, are together material, the procedures outlined in this ISA (UK and Ireland) would need to be considered.

When the principal auditor uses the work of another auditor, the principal auditor should determine how the work of the other auditor will affect the audit (paragraph 2).

In the UK and Ireland, when planning to use the work of another auditor, the principal auditor's consideration of the professional competence of the other auditor should include consideration of the professional qualifications, experience and resources of the other auditor in the context of the specific assignment. (paragraph 7.1)

175. The principal auditor considers in particular the competence and capability of the other auditor having regard to the laws, regulation and industry practice relevant to the component to be reported on by the other auditor and whether the other auditor has access to relevant expertise, for example in the valuation of financial instruments, appropriate to the component's business.
176. Further procedures may be necessary for the auditor of an investment business where audit work in support of the audit opinion is undertaken by an audit firm that is not subject to the UK audit regulatory regime. Where an overseas firm of the auditor (or an audit firm independent of the auditor) is undertaking audit procedures on a branch, or division or shared service centre of the investment business, the auditor must have due regard to the requirements in the Audit Regulations²⁵ to ensure all relevant members of the engagement team are and continue to be fit and proper, are and continue to be

25 Audit Regulations and Guidelines – December 2005 issued by the Institute of Chartered Accountants in England and Wales, the Institute of Chartered Accountants in Scotland and the Institute of Chartered Accountants in Ireland

competent and are aware of and follow these Audit Regulations and any related procedures and requirements established by the audit firm. This includes the auditor's duty to report direct to the FSA in certain circumstances. More detailed consideration of the auditors' duty to report to the FSA is set out in the section of this Practice Note dealing with ISA (UK and Ireland) 250.

ISA (UK AND IRELAND) 620: USING THE WORK OF AN EXPERT

Background note

The purpose of this ISA (UK and Ireland) is to establish standards and provide guidance on using the work of an expert as audit evidence.

When using the work performed by an expert, the auditor should obtain sufficient appropriate audit evidence that such work is adequate for the purposes of the audit. (paragraph 2)

177. Given the complexity, subjectivity and specialist nature of the valuation of derivative and other financial instruments not traded in an active market, the auditor may involve an expert in elements of the audit of these areas.
178. Where the auditor uses an expert as part of the audit, the auditor remains solely responsible for the audit of the investment business's financial statements and will not refer to the work of the expert within the auditor's report.

ISA (UK AND IRELAND) 700: THE AUDITOR'S REPORT ON FINANCIAL STATEMENTS

Background note

The purpose of this ISA (UK and Ireland) is to establish standards and provide guidance on the form and content of the auditor's report issued as a result of an audit performed by an independent auditor of the financial statements of an entity. Much of the guidance provided can be adapted to auditor reports on financial information other than financial statements.

In the UK and Ireland:

- (a) The auditor should distinguish between the auditor's responsibilities and the responsibilities of those charged with governance by including in the auditor's report a reference to a description of the relevant responsibilities of those charged with governance when that description is set out elsewhere in the financial statements or accompanying information; or
- (b) Where the financial statements or accompanying information do not include an adequate description of the relevant responsibilities of those charged with governance, the auditor's report should include a description of those responsibilities. (paragraph 9-1)

179. If the auditor of an investment business is to include a qualification in the statutory audit report, the auditor considers whether written notice will need to be given in accordance with the relevant Regulations under FSMA 2000. Guidance on such considerations is contained in the section on ISA (UK and Ireland) 250 Section B.

AUDITOR'S REPORT TO THE FSA

General

180. Auditors making a report on client assets to the FSA under SUP 3.10 usually also carry out an audit of the entity's annual financial statements, which have been prepared for statutory purposes, in accordance with ISAs (UK and Ireland)²⁶. Accordingly, the work that auditors perform in respect of their report to the FSA usually represents a set of additional procedures which, in conjunction with the evidence drawn from the audit work carried out in relation to the annual financial statements, will enable them to report as required.

181. When undertaking such additional procedures, auditors have regard to the General Principles set out below.

The auditors' reporting responsibilities

182. The responsibility and scope of auditors reporting to the FSA is determined by the type of firm on which the auditor is reporting. The table in Appendix 7 summarises the scope of reporting for the various different types of investment business. Auditors determine the scope of their audit opinion prior to starting their work.

183. The auditors' report under SUP 3.10 broadly covers the following matters:

- whether the firm has maintained systems adequate to enable it to comply with the relevant client asset rules throughout the period since the last date at which a report was made;
- whether the firm was in compliance with the relevant client asset rules at the date as at which the report has been made;
- when a subsidiary of the firm is a nominee company in whose name custody assets of the firm are registered, whether that nominee company has maintained throughout the year systems for the custody, identification and control of custody assets which:
 - are adequate; and
 - include 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;
- if there has been a secondary pooling event during the period, the firm has complied with the relevant client money distribution rules in relation to that pooling event.

²⁶ The Government changed the relevant legislation to allow certain small investment firms that satisfy the size criteria to take advantage of the small companies audit exemption, with effect from 31st December 2006 year ends.

184. In discharging their reporting responsibilities regarding an investment business, auditors have particular regard to any changes in the requirements of the FSA in force during the period to which the report relates.

General Principles

185. The General Principles applicable to reporting on client assets are as follows:

- Auditors agree the terms of the engagement with the investment business and record them in writing (Paragraphs 201 to 203).
- Auditors comply with ethical guidance issued by their relevant professional body (Paragraph 204)
- Auditors familiarise themselves with the relevant rules contained in the FSA Handbook (Paragraphs 205 to 208)
- Auditors take steps to ensure that any delegated work is directed, supervised and reviewed in a manner which provides reasonable assurance that such work is performed competently (Paragraphs 209 to 215).
- Auditors plan the work to be undertaken so as to perform that work in an effective manner, taking into account their other reporting responsibilities (Paragraphs 216 to 227).
- Auditors consider materiality and its relationship with the risk of material misstatement in the report to the FSA in planning their work and in determining the effect of their findings on their report (Paragraph 228).
- When using the work of others, auditors assess their objectivity and competence and obtain sufficient appropriate evidence that such work is adequate for the purposes of the report (Paragraphs 229 and 230).
- Auditors carry out procedures designed to obtain sufficient appropriate evidence on which to base their opinions (Paragraph 231 and Appendix 2).
- Auditors obtain written confirmation of appropriate representations from management before their report is issued (Paragraphs 232 and 233).
- Auditors record in their working papers:
 - (a) details of the engagement planning;
 - (b) the nature, timing and extent of the procedures performed in relation to their auditors' report to the regulator, and the conclusions drawn; and
 - (c) their reasoning and conclusions on all significant matters which require the exercise of judgment (Paragraphs 234 to 239).
- Auditors undertake their work with an attitude of professional scepticism (Paragraphs 240 and 241).

- The auditor addresses his report to the FSA explaining the basis of the auditor's work (including a statement of compliance with this Practice Note) and expressing a clear opinion that complies with the requirements of the FSA rules (Paragraphs 242 to 255).
- Auditors consider the matters which have come to their attention while performing their procedures and whether they should be included in a report to those charged with governance (Paragraphs 256 to 263).
- If the auditor becomes aware of matters of material significance to the FSA, they report such matters directly to the FSA without delay (see paragraphs 63-76 relating to Section B of ISA (UK and Ireland) 250).

The auditor's report

186. The FSA classifies each of its firms into a prudential category depending on the type of business it is permitted to conduct. The category determines the opinions required in the auditors' report.

187. In the case of banks and building societies which undertake designated investment business, the audit report is also limited to that required under SUP 3.10 (which relates to client assets), except that the auditor is not required to provide an opinion on any nominee companies used. The example report set out in Appendix 1.1 is suitable for those firms where reporting is required under SUP 3.10.

188. The FSA's rules place a specific obligation on the auditor to submit the audit report to the FSA directly. Consequently, if the auditor is unable to submit the report within the timeframe specified, he will be in breach of the FSA's rules and is required to notify the FSA of that fact, and provide an explanation of why the deadline cannot be met.

189. It is possible under the rules to prepare the report on client money and custody assets as at a different date to the firm's accounting reference date. The deadline for submission would be four months after the end of the period on which the auditor is reporting. Subsequent client assets reports may be submitted covering any period of up to 53 weeks commencing on the date on which the previous report ended.

Method of submission of reports to the FSA

190. The FSA has made specific rules which apply to all reports submitted to it; these are set out in SUP 16.3.6R to SUP 16.3.13R. Key provisions are:

- the report must contain the firm's FSA reference number and be marked for the attention of its normal supervisory contact;
- the coversheet contained in SUP 16 Ann 13R must be used;
- the report may be submitted by e-mail;

- the return may be faxed by the deadline;
- if the deadline is not a normal business day, then the report can be submitted by the next business day after the due date.

COMPONENTS OF THE AUDITOR'S OPINION

Opinion on client money and custody assets [SUP3.10]

Introduction

191. Certain investment businesses are not required to have a statutory audit of their financial statements but are, nevertheless, required to appoint an auditor²⁷ to make a client asset report to the FSA.
192. This section has been developed for use by auditors who are appointed to make a client asset report regardless of whether or not they have been appointed statutory auditor of the investment business.

Client Asset Reports

193. SUP 3.10 of the FSA Handbook 'Duties of auditors: notification and report on client assets' broadly requires the auditors of firms, to which the Section applies, to submit a report to the FSA, signed in its capacity as auditor, which states whether in the auditor's opinion:
- (a) the firm has maintained 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 as at which a report was made;
 - (b) the firm was in compliance with the custody rules, the collateral rules and the client money rules at the date as at which the report has been made;
 - (c) if there has been a secondary pooling event during the period, the firm has complied with the rules in CASS 4.4, and/or CASS 7.9 (Client money distribution) in relation to that pooling event²⁸.
194. If an investment business claims not to hold client money or custody assets the auditor is required to report whether anything has come to his attention that causes the auditor to believe that the firm held client money or custody assets during the period covered by the report²⁹. Guidance for auditors with respect to investment businesses that do not hold client assets is included in Appendix 2.
195. The period covered by a client asset report is required to end not more than 53 weeks after the period covered by the previous report on such matters or, if none, after the investment business is authorised or becomes a firm to which SUP 3.10 applies³⁰.

27 In this guidance the expression 'auditor' is used in order to be consistent with the terminology used in Section 3.10 of the FSA Handbook.

28 SUP 3.10.4R(1) and 3.10.5R

29 SUP 3.10.4R(2)

30 SUP 3.10.6R

196. SUP 3.10 also contains rules concerning the timing of the submission of the client assets report and the method of submission of reports.

Engagement acceptance and continuance

197. In determining whether the scope of the engagement is expected to be sufficient to support the required report, the auditor considers whether there appear to be any significant limitations on the scope of the auditor's work. In particular, the auditor ascertains whether the directors of the investment business intend to comply with the relevant regulatory requirements.
198. The nature of investment businesses is one of rapidly changing and evolving markets. Often investment businesses develop new products and practices which may require specialised auditing and accounting responses. It is, therefore, important that the auditor is familiar with current practice.
199. In determining whether the persons who are to perform the engagement (the proposed engagement team) collectively possess the necessary professional competency the auditor assesses whether they, (and those with whom they intend to consult), have sufficient knowledge of the specific aspect of the investment industry within which the investment business operates and its corresponding products. The auditor also considers the extent to which the engagement team has sufficient knowledge of the regulatory framework within which the investment business operates commensurate with their roles in the engagement.
200. The knowledge requirements regarding aspects of the investment industry and the regulatory framework may vary between different types of investment business such as:
- BIPRU investment firms (including UCITS investment firms);
 - Exempt CAD firms;
 - Securities and futures firms;
 - Investment management firms;
 - Personal investment firms;
 - UCITS firms.

Agreeing the terms of the engagement

201. Generally, an engagement letter is prepared by the auditor, covering all aspects of the engagement, and accepted in writing by the directors of the investment business³¹. As

31 Where the auditor is also appointed as statutory auditor a combined engagement letter will usually be issued.

the FSA does not need to approve the appointment of an auditor the FSA is not usually an addressee of the engagement letter.

202. However, the FSA is entitled to seek to satisfy itself that an auditor appointed by the investment business is independent and has the necessary skills, resources and experience³². The auditor is required to co-operate with the FSA³³ and to notify the FSA if the auditor ceases to be the auditor of the investment business.

203. Matters which the auditor may refer to in the engagement letter are:

- the responsibility of the directors/senior management to comply with applicable legislation and FSA Handbook rules and guidance including the need to keep the FSA informed about the affairs of the investment firm;
- the statutory right and duty of the auditor to report directly to the FSA in certain circumstances;
- the requirement to co-operate with the auditor (SUP 3.6.1R). This includes taking steps to ensure that, where applicable, each of its appointed representatives and material outsourcers provides the auditor with the same right of access to records, information and explanations as the authorised investment firm itself is required to provide the auditor. It is a criminal offence for an investment business or its officers, controllers or managers to provide misleading information to the auditor;
- the need for the investment business to make the auditor aware when it appoints a third party (including another department or office of the same audit firm) to review, investigate or report on any aspects of its business activities that may be relevant to the audit of the financial statements and to provide the auditor with copies of reports by such a third party promptly after their receipt.

Ethical guidance

204. As the Ethical Standards (ES1 to ES 5) issued by the APB apply only to the audit of financial statements they do not apply to assurance engagements to make a client assets report. The UK accountancy bodies have issued their own Codes of Ethics that are to be applied in the conduct of, among others, assurance engagements undertaken by professional accountants in public practice.

Legal and regulatory requirements

205. The Financial Services and Markets Act 2000 (FSMA 2000) establishes the high level regulatory framework for the whole financial sector including investment businesses. Appendix 3 of this Practice Note sets out the main parts of FSMA 2000 that are relevant to investment businesses.

32 SUP 3.4.4G, 3.4.7R and 3.4.8G

33 SUP 3.8.2R

206. An auditor that is appointed to make a client asset report to the FSA is subject to the auditor's statutory right and duty to report to the FSA described in paragraph 22 of this Practice Note. Guidance on the identification of matters to be reported to the regulators is set out in the section dealing with ISA (UK and Ireland) 250 Section B.

207. Auditors are also aware of other legislation which investment businesses are required to comply with. The following are examples of such legislation:

- Insider dealing (Securities and Regulated Market) Order 1994.
- Criminal Justice Act 1993.
- Proceeds of Crime Act 2002.
- Money Laundering Regulations 2007.

208. Set out below are the requirements of the FSA Handbook that are directly relevant to engagements for reporting to the FSA on client assets under SUP 3.10.5R (1) and (2). When reporting under SUP 3.10.5R(3) the relevant requirements are CASS 4.4 and 7.9.

CASS 1	<i>Application and general provisions</i>
1.1	Application and purpose
1.2	General application: who? what?
1.3	General application: where?
1.4	Application: particular activities
1.5	Application: electronic media and E-Commerce
CASS 2	<i>Non-directive custody rules</i>
2.1	Custody
2.2	Segregation, registration and recording, and holding
2.3	Client agreement and client statements
2.4	Custodian agreement
2.5	Use of a safe custody investment and stock lending
2.6	Operation
CASS 3	<i>Collateral</i>
3.1	Application and Purpose
3.2	Requirements
CASS 4	<i>Non-directive client money rules</i>
4.1	Application and Purpose
4.2	Statutory trust

4.3	Segregation and operation of client money accounts
CASS 6	Custody: MiFID business
6.1	Application
6.2	Holding of client assets
6.3	Depositing assets with third parties
6.4	Use of financial instruments
6.5	Records, accounts and reconciliations
CASS 7	Client money: MiFID business
7.1	Application and Purpose
7.2	Definition of client money
7.3	Organisational requirements: client money
7.4	Segregation of client money
7.5	Transfer of client money to a third party
7.6	Records, accounts and reconciliations
7.7	Statutory trust
7.8	Notification and acknowledgement of trust
7 Annex 1	
CASS 8	Mandates
8.1	Application

Quality control

209. International Standard on Quality Control (UK and Ireland) 1 'Quality control for firms that perform audits and reviews of historical financial information, and other assurance and related service engagements' provides standards and guidance on the system of quality control that a firm establishes.

210. Elements of quality control that are relevant to an individual engagement to report on client assets include:

Leadership responsibilities for quality on the engagement.

211. The engagement partner takes responsibility for the overall quality on each client asset report engagement to which that partner is assigned.

Ethical requirements

212. The engagement partner evaluates whether members of the engagement team have complied with ethical requirements applicable to the client asset report engagement.

Assignment of engagement teams.

213. The engagement partner assesses whether the engagement team collectively has the appropriate capabilities, competence and time to perform the client asset engagement in accordance with the guidance in this Practice Note and regulatory and legal requirements and to enable a report to be made to the FSA that is appropriate in the circumstances.

Engagement performance

214. The engagement partner takes responsibility for the direction, supervision and performance of a client asset engagement. Before the report is issued to the FSA the engagement partner, through review of the engagement documentation and discussion with the engagement team, determines whether sufficient appropriate evidence has been obtained to support the conclusions reached.

Consultation

215. The engagement partner is responsible for the engagement team undertaking appropriate consultation on difficult or contentious matters and assesses whether the nature and scope of and conclusions resulting from such consultations are documented and agreed with the party consulted. The engagement partner also determines that conclusions resulting from consultations have been implemented.

Planning and performing the engagement

216. Planning involves developing an engagement plan consisting of a detailed approach for the nature, timing and extent of evidence gathering procedures to be performed and the reasons for selecting them. The nature and extent of planning activities will vary with the engagement circumstances, for example the size and complexity of the investment business and the auditor's previous experience with it.

217. Examples of the main matters to be considered include:

- the terms of the engagement;
- whether the timetable is realistic;
- the auditor's understanding of the investment business and its environment;
- identifying potential problems that could impact the performance of the engagement;
- the need for the involvement of experts.

218. Planning is not a discrete phase, but rather an iterative process throughout the engagement. As a result of unexpected events, changes in conditions or the evidence obtained from the results of evidence-gathering procedures, the auditor may need to revise the overall strategy and engagement plan, and thereby the resulting planned nature, timing and extent of further procedures.

219. A preliminary review of the available information may provide an indication of potential issues that might need to be addressed in carrying out the engagement. If the preliminary review indicates that there are factors that may give rise to a modification of the auditor's report then such factors are reported immediately to those charged with governance of the authorised investment firm and, where required by the FSA's rules, to the FSA³⁴.
220. Changes in circumstances, or unexpected results of work carried out, may require the plan to be amended as work progresses. Any such amendments are documented. Where the changes affect the work set out in the engagement letter, the engagement letter is also amended as necessary following agreement with the directors.

Risk of non-compliance with FSA Rules

221. A risk is a threat that circumstances, events or actions will adversely affect an investment business's ability to comply with the applicable FSA Rules. A firm's internal organisation and the environment in which it operates may be continually changing. An effective system of internal control, therefore, depends on a thorough and regular evaluation of the nature and extent of the risks to which the firm is exposed.
222. Once identified, risks can then be assessed by the directors in terms of their likelihood (probability) and potential impact (materiality).

Assurance engagement risk

223. 'Assurance engagement risk,' in the context of client asset reports, is the risk that the auditor expresses an unmodified opinion that the investment business:
- (a) maintained throughout the period since the last date as at which a report was made systems adequate to enable it to comply with the FSA's custody rules, collateral rules and client money rules,
 - (b) was in compliance with the custody rules, the collateral rules and the client money rules at the date as at which the report was made, and
 - (c) the firm has complied with the rules in CASS 4.4 and/or CASS 7.9 (Client money distribution) in relation to a secondary pooling event during the period,

when there is insufficient appropriate evidence available to support the making of these statements.

Appendix 2 provides guidance to auditors on the work normally carried out in order to form an opinion on client assets.

34 See SUP 3.10.8B

Assessing assurance engagement risk

224. When assessing assurance engagement risk the main factors that will be considered include:

- (a) the scope of the investment business's permission in relation to the holding of client assets;
- (b) the extent of investment management discretion permitted;
- (c) the introduction of new rules;
- (d) changes to existing legislation or rules;
- (e) rule waivers granted or special conditions imposed by the FSA; and
- (f) the auditor's understanding of the systems and controls regarding client assets.

225. In making an assessment of risks, auditors would normally meet senior management and the Compliance Officer of the investment business. They would also consider the following:

- (a) operational manuals;
- (b) documentation of systems and controls;
- (c) compliance monitoring programmes and results;
- (d) the records maintained by the business of any rule breaches and notifications to the regulator that may have occurred during the period;
- (e) correspondence with the FSA, relating to financial returns and any other matters;
- (f) the results of the most recent inspection visit made by the FSA; and
- (g) the register of complaints received from clients during the period.

226. As compliance by the investment business with the client asset rules is a continuing obligation, the auditor reports on the adequacy of the accounting records and systems throughout the period under review. However the auditor normally tests controls, transactions and reconciliations at particular points in time rather than continuously throughout the accounting period. If the auditor has obtained sufficient evidence from the results of their testing they may rely on this evidence to conclude on the adequacy of records and systems throughout the period.

227. If there has been a system change during the period covered by a report, the auditor considers the system in force both before and after the change. If the change occurred early in the period and the evidence of previous audits has produced satisfactory conclusions, the auditor may decide to perform only limited procedures on the system concerned.

Materiality

228. The auditors plan and perform their audit so that they obtain sufficient evidence for their opinion. When doing so, they consider materiality, recognising the nature and scale of the investment business concerned. It is not feasible, or necessary, for the auditors to examine every transaction reflected in the records, or to achieve complete satisfaction that the accounting records are maintained accurately and systems operate totally effectively. They have a reasonable expectation of detecting fraud, other irregularities and errors which would be material to the interests of the clients of the investment business, taken as a whole.

Use of an expert

229. The auditor should understand the work for which an expert is used to an extent that is sufficient to enable the auditor to accept responsibility for the opinion provided to the FSA. The auditor also obtains sufficient appropriate evidence that the expert's work is adequate for the purposes of the engagement.

230. If the auditor has also been appointed as statutory auditor of the financial statements of the investment business, when planning and performing the audit, the auditor always keeps in mind the need for audit evidence in relation to the existence of client assets and the accuracy of the investment business's records.

Detailed guidance on control objectives and audit evidence

231. Detailed guidance on the control objectives and audit evidence is set out in Appendix 2. Auditors apply their judgment in determining the extent and nature of their work which is based on the following general requirements:

- (a) the auditors understand the business and the environment in which it operates;
- (b) the auditors review the firm's systems and consider whether these are adequate for control and accounting purposes;
- (c) the auditors test those systems and controls to establish that they are operating effectively.

Representation letter

232. Written confirmation of representations made by the directors on matters material to the auditor's report on client assets is ordinarily obtained. These representations also

encompass statements or opinions attributed to directors, management, employees or agents of an investment business that are relied upon by the auditor.

233. Representations by the directors of the investment business cannot replace the evidence that the auditor could reasonably expect to be available to support the opinion given. An inability to obtain sufficient appropriate evidence regarding a matter could represent a limitation of scope even if a representation has been received on the matter.

Documentation

234. The information to be recorded in working papers is a matter of professional judgment since it is neither necessary nor practical to document every matter considered by the auditor. The auditor prepares documentation sufficient to enable an experienced auditor, having no previous connection with the engagement, to understand:

- (a) the nature, timing, and extent of the procedures performed to meet the FSA's requirements with respect to client asset reports;
- (b) the results of the procedures and the evidence obtained; and
- (c) significant matters arising during the engagement, and the conclusions reached thereon and significant professional judgments made in reaching those conclusions.

235. In documenting the nature, timing and extent of procedures performed, the auditor records:

- (a) the identifying characteristics of the specific items or matters being tested;
- (b) who performed the procedures and the date such procedures were completed; and
- (c) who reviewed the work performed and the date and extent of such review.

236. The auditor documents discussions of significant matters with the investment business, the FSA and any experts engaged by the auditor in connection with the engagement, including when and with whom the discussions took place.

237. If the auditor has identified information that is inconsistent with the auditor's final conclusion regarding a significant matter, the auditor documents how the inconsistency was addressed in forming the final conclusion.

238. The auditor completes the assembly of the final engagement file on a timely basis after the date of the auditor's report. Once the final engagement file has been completed documentation is not deleted or discarded before the end of its retention period.

239. If the auditor finds it necessary to modify existing engagement documentation or add new documentation after the final engagement file has been assembled the auditor documents:

- (a) when and by whom they were made and (where applicable) reviewed;
- (b) the specific reasons for making them; and
- (c) their effect, if any, on the auditor's conclusions.

Professional scepticism

240. An attitude of professional scepticism is essential to ensure that the auditor makes a critical assessment, with a questioning mind, of the validity of evidence obtained and is alert to evidence that contradicts or brings into question the reliability of audit evidence such as documents or representations.

241. Whilst the auditor may proceed on the basis that information and explanations provided by the directors and management of the investment business are reliable, he assesses them critically and, where appropriate, considers them in the context of his knowledge and findings derived from any other areas of work undertaken with the same client.

Reporting

242. The auditor addresses his report to the FSA and in the report :

- (a) identifies the matters to which the report relates;
- (b) addresses all matters that are required by the engagement letter;
- (c) explains the basis of the auditor's work and in particular make a statement of compliance with this Practice Note;
- (d) contains a clear expression of opinion that complies with the requirements of the FSA Rules;
- (e) includes the auditor's manuscript or printed signature;
- (f) includes the auditor's address; and
- (g) includes the date.

243. The report is not for the use of third parties. Auditors may wish to ensure that the management of the investment business does not provide the report to anyone other than the FSA (for example, in the letter of engagement or a covering letter with which the report is transmitted to the client). The restriction on distribution to third parties could also be mentioned in the body of the report itself.

244. In view of the fact that the auditor reports to the FSA on his client's compliance with the regulator's rules it is not usually necessary for the auditor to include in his report a description of the work performed.

245. Where a firm is placing reliance on any rule waiver, modification or individual guidance given to it, and this is relevant to any opinion given by the auditor, then the auditor

satisfies himself that it is appropriate for the firm to do so. Guidance on the circumstances under which a firm may place reliance on such material is given in Chapters 8 and 9 of the Supervision Manual. The auditor specifically mentions such matters in his report.

246. Before signing the report, the auditor considers whether it is appropriate to make the required report, having regard to the scope of the work performed and the audit evidence obtained.
247. The date of the report is the date on which the auditor signs the report as being suitable for release. However, the auditor does not sign the report (whether modified or not) unless sufficient appropriate evidence has been obtained and all planned procedures have been finalised. Such procedures include the review procedures of both the engagement partner and the engagement quality control reviewer.

An example of a report to the FSA on Client Assets under SUP 3.10 expressing an unmodified opinion is set out in Appendix 1.1.

Modified opinions

248. The auditor does not express an unmodified opinion when there has been a limitation on the scope of the auditor's work, that is circumstances prevented, or there were restrictions imposed that prevented, the auditor from obtaining evidence required to reduce engagement risk to the appropriate level.
249. If one or more of the applicable requirements of the FSA Handbook have not been met the auditor should specify in his report those requirements and the respects in which they have not been met³⁵.
250. If the auditor is unable to form an opinion as to whether one or more of the applicable requirements of the FSA Handbook have been met, the auditor should specify those requirements in the report and the reasons why the auditor has been unable to form an opinion³⁶.
251. FSMA 2000 defines rules as including evidential provisions such that, for the purposes of an auditor's report to the FSA, a breach of evidential provisions may indicate a breach of rules. If the auditor considers that an investment business has breached the underlying rule, then the auditor must report that fact in respect of both the underlying rule and the evidential provision and should give both references in the report. If the auditor considers that a business has breached an evidential provision but, nevertheless is satisfied that the firm is in compliance with the underlying rule, then the report refers to the breach of the evidential provision.

35 SUP 3.10.9R

36 SUP 3.10.10R

252. In considering any matter indicating a possible breach of the rules, auditors analyse the circumstances in order to identify its cause, and establish the action management has taken or intends to take to correct the matter. If the matter leads to a qualification and appropriate effective action to correct the matter has been taken (and the auditors are satisfied that this is so), they may choose to report this fact to the FSA so as to ensure the FSA is fully informed about the likelihood of any repetition of the breach in question. However, the prime responsibility for reporting corrective action rests with management.
253. Although the rules do not provide that trivial breaches can be disregarded, where small exceptions are discovered this of itself would not necessarily require the auditor to qualify their opinion.
254. Auditors exercise care in forming a judgment as to whether a particular breach is trivial, particularly bearing in mind the overriding objective of safeguarding client assets. Steps will be taken to ensure that all staff involved in the audit are aware that the judgment of whether a particular matter is trivial depends on different criteria from any quantitative measure of materiality which may be applied to the audit of the investment business's financial statements.
255. Matters giving rise to a significant risk of loss to investors may also require a report to the FSA under the statutory duty provisions. Such reports will normally be made following discussion with the authorised business: however, ISA(UK and Ireland) 250 emphasises that where the auditors conclude that a duty to report arises, they should bring the matter to the attention of the FSA without undue delay.

Other reporting responsibilities

256. The auditor considers other reporting responsibilities, including the appropriateness of communicating relevant matters, arising from making the client asset report, with management and those charged with governance.
257. The FSA Handbook does not require the auditor of an investment business to submit a management letter to an entity commenting on the entity's internal controls.
258. However, where such letters are prepared and submitted they provide a means for the auditor to provide constructive observations arising from the audit work on client assets. Communication on a timely basis enables the entity to take appropriate action particularly in circumstances where uncorrected weaknesses may lead to the auditor modifying his opinion to the FSA on client assets
259. 'Those charged with governance' include the directors (executive and non-executive) of a company or other body, the members of an audit committee where one exists, the partners, proprietors, committee of management or trustees of other forms of entity, or equivalent persons responsible for directing the entity's affairs.

260. In this guidance, 'relevant matters of governance interest' are those that arise from the engagement to make the client asset report and, in the auditor's opinion, are both important and relevant to those charged with governance. Relevant matters of governance interest include only those matters that have come to the attention of the auditor while performing the engagement to make the client asset report.
261. Those charged with governance are likely to find particularly relevant information concerning material weaknesses in internal control, particularly weaknesses relevant to the firm's ability to comply with the custody, collateral or client money rules. The auditor does not normally need to communicate information concerning a material weakness of which those charged with governance are aware and in respect of which, in the view of the auditor appropriate corrective action has been taken, unless the weakness is symptomatic of broader weaknesses in the overall control environment and there is a risk that other material weaknesses may occur. Material weaknesses of which the auditor is aware are communicated where they have been corrected by management without the knowledge of those charged with governance.
262. The auditor considers whether the two way communication between the auditor and those charged with governance has been adequate for an effective audit and, if it has not, takes appropriate action.
263. If the two-way communication between the auditor and those charged with governance is inadequate there is a risk that the auditor may not obtain all the evidence required to provide a report on client assets. If the auditor concludes that the two way communication is inadequate for the purposes of the audit, the auditor considers withdrawing from the engagement.

AUDITOR'S REVIEW REPORTS ON INTERIM NET PROFITS

264. The FSA's capital rules for investment business do not permit certain firms to include interim net profits within reserves in tier 1 capital unless they have been externally verified by the auditor. Trading book profits can be included without external review in Tier 3 capital.
265. Interim profits in this context broadly means, net profits of the investment business as at a date specified by the investment business after the end of its most recently audited financial year end and up to and including its next financial year end, calculated after deductions for tax, foreseeable dividends and other appropriations.
266. GENPRU does not include specific guidance as to what constitutes an external verification. However 'verification' as used in the context of GENPRU is understood to indicate a degree of assurance which is lower than that given by a full audit. An engagement to 'verify' interim net profits may therefore be taken to be a review engagement, and an opinion may be given in terms of negative assurance.
267. As an external 'verification' of interim net profits does not require a full scope audit it will be important for the FSA, in considering the adequacy of the 'verification' of interim profits, to be informed of the procedures that have been undertaken by the auditors, in support of their opinion. This is particularly important in the case of investment businesses where no prescribed procedures have been established by the FSA in rules or guidance. Consequently the detailed scope of the work undertaken by the auditor in support of his opinion is listed in the auditors' report or included in the report by reference to the letter of engagement where the programme of work has been laid down.
268. In undertaking the review the auditor normally performs the following procedures:
- (a) satisfies himself that the figures forming the basis of the interim net profits have been properly extracted from the underlying accounting records (which in the context of groups include consolidation schedules);
 - (b) reviews the accounting policies used in calculating the interim net profits so as to obtain comfort that they are consistent with those normally adopted by the investment business in drawing up its annual financial statements and are in accordance with either UK GAAP or EU IFRS as appropriate;
 - (c) performs analytical procedures on the results to date, including comparisons of actual performance to date with budget and with the results of prior period(s);
 - (d) discusses with management the overall performance and financial position of the investment business;
 - (e) obtains adequate comfort that the implications of current and prospective litigation, all known claims and commitments, changes in business activities and impairment

provisions have been properly taken into account in arriving at the interim net profits;
and

- (f) follows up significant matters of which the auditor is already aware in the course of auditing the investment business's financial statements.

The auditor may also consider obtaining appropriate representations from management.

269. There may be some circumstances in which the auditor considers that additional work is required, for example:

- if the control environment surrounding the preparation of the interim net profits is evaluated as weak;
- if the results of the procedures undertaken above are not fully consistent with the interim net profits as reported; or
- if there has been a significant change to the accounting system.

270. The report is addressed to the directors of the investment business. An example auditor's report on interim net profits is set out in Appendix 1.2.

APPENDIX 1

ILLUSTRATIVE EXAMPLES OF AUDITOR'S REPORTS

This appendix contains the following example auditor's reports:

- 1.1 – Auditor's report on client assets
- 1.2 – Auditor's review report on interim net profits

1.1 AUDITOR'S REPORT ON CLIENT ASSETS UNDER SUP 3.10

Independent Auditor's report to the Financial Services Authority ('the FSA') in respect of ABC Limited for the year/period ended [date]

We report in respect of ABC Limited ('the firm') on the matters set out below.

Our report has been prepared in accordance with SUP 3.10.4R and is addressed to the FSA in its capacity as regulator under the Financial Services and Markets Act 2000.

Basis of opinion

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.

Systems and control procedures relating to client assets are subject to inherent limitations and, accordingly, errors or irregularities may occur and not be detected. Such procedures cannot be proof against fraudulent collusion, especially on the part of those holding positions of authority or trust. Furthermore, this opinion relates only to the year ended on () 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

Either

In our opinion:

- the firm has maintained systems adequate to enable it to comply with the custody rules, the collateral rules and the client money rules throughout the period [from.. to..] since the last date at which a report was made [See note];
- the firm was in compliance with the custody rules, the collateral rules and the client money rules [See note] at the date as at which the report has been made³⁷;
- [if applicable]³⁸ in relation to the secondary pooling event during the period, the firm has complied with the rules in CASS 4.4 and/or CASS 7.9 (Client money distribution) in relation to that pooling event.

37 In many cases this will be the year end date but need not be.

38 Guidance on secondary pooling events is not within the scope of this Practice Note

Or

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

The directors have stated that the firm did not hold [client money] [or] [custody assets] [delete as required] during the year. 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 year.

Nominee companies [if applicable]³⁹

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) were 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.

Registered Auditors

Address

Date

³⁹ This paragraph is only applicable 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 of the firm are registered.

Note: The requirements of the handbook that apply, and the wording of the opinion differ, depending on whether or not the firm holds both client money and assets or only one of these:

	Non-MiFID Business	MiFID Business
(i) Where the firm holds both client money and custody assets	CASS 2, CASS 3, CASS 4.1 to 4.3 apply Opinion refers to custody, collateral and client money rules	CASS 3, CASS 6 and CASS 7.1 to 7.8 apply Opinion refers to custody, collateral and client money rules
(ii) Where the firm holds custody assets but not client money	CASS 2 and CASS 3 apply Opinion refers to custody and collateral rules	CASS 3 and CASS 6 apply Opinion refers to custody and collateral rules
(iii) Where the firm holds client money but not custody assets	CASS 3 and CASS 4.1 to 4.3 apply Opinion refers to collateral and client money rules	CASS 3 and CASS 7.1 to 7.8 apply Opinion refers to collateral and client money rules

CASS 3 and reference to the collateral rules is not applicable in circumstances where the firm does not receive or hold collateral.

1.2 AUDITOR'S REVIEW REPORT ON INTERIM NET PROFITS

Review report by the auditors to the board of directors of XYZ Limited ('the company')

In accordance with our engagement letter dated [...], a copy of which is attached, we have reviewed the company's statement of interim net profits for the period from [...] to [...] set out on pages [...] to [...] of the attached [see Note 1]. That statement is the responsibility of, and has been approved by, the directors.

Our review did not constitute an audit, and accordingly we do not express an audit opinion on the interim profits. It has been carried out having regard to [see Note 2] of the FSA Handbook and Practice Note 21: The audit of investment businesses in the United Kingdom (Revised) issued by the Auditing Practices Board.

On the basis of the results of our review, nothing has come to our attention that causes us to believe that:

- the interim net profits have not been calculated on the basis of the accounting policies adopted by the company in drawing up its annual financial statements for the year ended [...];
- those accounting policies are not in accordance with the principles set out in [see Note 3]; and
- the interim net profits after tax amounting to £[...] as so reported are not reasonably stated.

Date

Note	<i>Wording for BIPRU investment firms⁴⁰</i>	<i>Wording for exempt CAD firms</i>	<i>Wording for investment management firms</i>	<i>Wording for UCITS firms</i>	<i>Wording for personal investment firms</i>
Note 1	Type of firm it was prior to 1 st January 2007: Investment management – financial return UCITS management – financial return Personal investment – retail mediation activities return Securities and futures – reporting statement	Type of firm it was prior to 1 st January 2007: Investment management – financial return Personal investment – retail mediation activities return Securities and futures – reporting statement	financial return	financial return	retail mediation activities return
Note 2	2.2.102R and 2.2.103G of GENPRU	9.3.4R or 13 1A.9R of IPRU (INV)	Table 5.2.2(1) of Chapter 5 of IPRU (INV)	Table 2.2.1R of UPRU	Appendix 13(1) of Chapter 13 of IPRU (INV)

40 BIPRU investment firms submit key data sheet FSA 009 together with the forms they were required to submit prior to 1st January 2007. Exempt CAD firms submit the forms they were required to submit prior to 1st November 2007.

Note 3	<p>Type of firm it was prior to 1st January 2007:</p> <p>Investment management – Section 4 table 1 of Annex 5R to chapter 16 of SUP</p> <p>UCITS management – Section 3 table 1 of Annex 16R to chapter 16 of SUP</p> <p>Personal investment – Paragraph 15 of the introduction in Annex 18BG to chapter 16 of SUP</p> <p>Securities and futures – Section 6 of Annex 10R to chapter 16 of SUP</p>	<p>Type of firm it was prior to 1st January 2007:</p> <p>Investment management – Section 4 table 1 of Annex 5R to chapter 16 of SUP</p> <p>Personal investment – Paragraph 15 of the introduction in Annex 18BG to chapter 16 of SUP</p> <p>Securities and futures – Section 6 of Annex 10R to chapter 16 of SUP</p>	Section 4 Table 1 of Annex 5R to Chapter 16 of the FSA's Supervision Manual	Section 3 Table 1 of Annex 16R to Chapter 16 of the FSA's Supervision Manual	Section 15 of Annex 18BG to Chapter 16 of the FSA's Supervision Manual
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APPENDIX 2

CLIENT ASSETS

- 1 This Appendix provides more detailed guidance to auditors on the work normally carried out in order to form an opinion on client assets in the auditor's report to the FSA. In particular it provides guidance on FSA's Client Assets Sourcebook ('CASS'). Auditors also need to familiarise themselves with CASS as there are differences between the MiFID and non-MiFID rules which may not be fully reflected in the examples below.

CASS is separated into the following sections:

- a) CASS 1 – Application and general provisions;
- b) CASS 2 – Non-directive custody rules;
- c) CASS 3 – Collateral;
- d) CASS 4 – Non-directive client money rules;
- e) CASS 5 – Client money (insurance mediation activity);
- f) CASS 6 – Custody (MiFID business);
- g) CASS 7 – Client money (MiFID business);
- h) CASS 8 – Mandates.

CASS 6 and 7 became effective on 1 November 2007 and apply to investment business within the scope of the MiFID. If a firm conducts both MiFID and non-MiFID business it may elect to apply the MiFID CASS rules to both types of activity.

When reporting to the FSA on whether the firm maintained systems adequate to enable it to comply with the rules in CASS the auditors will be reporting on CASS 2 and 4.1 to 4.3 (for non-MiFID business) and/or CASS 6 and 7.1 to 7.8 (for MiFID business) together with CASS 3 if applicable.

- 2 The main purpose of the rules in CASS is to ensure that the investment business safeguards client assets. The rules aim to minimise errors, make fraud more difficult to perpetrate, and make it easier for both errors and fraud to be detected. A further purpose is to ensure that, in the event of insolvency of the investment business, client assets are protected from the claims of its general creditors and, in the case of client money, from any right of set off by institutions which hold the money. This purpose is also consistent with Principle 10 of the FSA's Principles.
- 3 The rules require investment businesses to maintain a high standard of custodianship and associated record-keeping. Management of an investment business is responsible

for establishing and maintaining adequate accounting records and systems and controls. This recognises the position of trust under which client assets are held.

- 4 This Appendix is separated into the following sections:
- (a) Custody assets
 - (b) Client money
 - (c) No client assets

Each section sets out the relevant planning considerations.

- 5 This Appendix is to assist in determining the scope of the work for each individual audit. However, it is not intended to limit or replace individual judgement, initiative, and vigilance. Audit procedures are designed to meet the requirements of the particular situation, giving careful consideration to the size and type of organisation and the system of internal accounting control; this is a matter that requires the exercise of professional judgement in the light of the circumstances of each particular case.
- 6 Where the auditors discover that the systems have failed or material differences have arisen, they consider the implications these may have on other areas of their work, on their reporting obligations and, in particular, on the 'truth and fairness' of the financial statements.

CUSTODY ASSETS

Introduction

- 7 Custody assets comprise safe custody investments along with any other assets which may be held with such investments on a client's behalf. Firms must apply the rules to those assets which are not safe custody investments in a manner appropriate to the nature and value of those assets.

Broadly, safe custody investments are designated investments held for or on behalf of a client. Designated investments are set out in Schedule 2 part 2 to FSMA 2000 and in Part III of the Regulated Activities Order (Specified Investments). Examples of designated investments include:

- (a) shares and stock in the capital of a company;
- (b) debentures;
- (c) government and public securities;
- (d) warrants or other instruments entitling the holder to subscribe for investments;
- (e) certificates representing securities;
- (f) units in a collective investment scheme;

any of which belong to the client of an investment business. These investments may be held in the form of collateral. In addition, arranging custody for a client as well as providing custody is covered by the legislation.

- 8** For the particular investment business, the auditors understand what may constitute custody assets. They consider all situations and transaction types that may be entered into by the investment business, including arranging custody. Although the investment business may consider that a particular area is not covered by the rules relating to custody assets, the auditors are alert to situations where this is incorrect and the investment business is in breach of the rules as a result.

Planning the custody assets work

- 9** The auditors' work on custody assets will be planned in relation to the three reporting requirements. For custody assets, the main areas that need to be addressed by the auditors, to enable them to fulfil their reporting requirements are:
- (a) adequate accounting records;
 - (b) adequate systems and controls for:
 - (i) safe custody and proper control of custody assets, including the sending of periodic statements;
 - (ii) proper registration and segregation of custody assets;
 - (iii) compliance with reconciliation requirements;
 - (c) compliance with the relevant rules at the year end date.
- 10** The control objectives that a business administering or holding custody assets or collateral will need to meet and the evidence that may be available to the auditors upon which they can base their conclusions are outlined below.
- 11** Not every business, particularly a smaller one, will be able to meet all these objectives through the establishment of formal controls and segregation of duties. In consequence, not all the evidence indicated below will be available in every case.
- 12** This does not necessarily mean that the business has weak controls or that there is insufficient evidence for the auditors to give an opinion. The business may well have adequate controls due to close supervision by the management, taking into account the low volume of custody assets handled. It may also use the services of a custodian, the requirements for use of which are set out in the rules.
- 13** In some cases, therefore, the auditors may place greater reliance on observation and enquiry for their audit evidence than inspection of documentation. In doing so, they need to bear in mind that informal systems are more prone to error and fraud, and that their

presence and enquiries may influence the manner in which procedures are operated at that time.

- 14 This Appendix is arranged by reporting requirement as these are what the auditors bear in mind throughout the planning of their audit.

Adequate accounting records

Control objectives

- 15 The main factors that will be considered are:
- (a) proper and prompt recording of the movements of documents (this includes all documents, including those relating to the investment business's own investments as there is a risk of teeming and lading and having client title documents mixed with the investment business's own documents);
 - (b) proper and prompt recording of all purchases and sales of investments on behalf of clients;
 - (c) proper and prompt recording of other assets held on behalf of clients;
 - (d) records in agreement with the statements sent to clients of assets held on their behalf;
 - (e) reconciliations carried out in accordance with the rules; and
 - (f) proper and prompt accounting for benefits, such as bonus or scrip issues accruing to clients.

Evidence

- 16 The main factors that will be considered are:
- (a) evidence that documents of title are recorded immediately on receipt;
 - (b) evidence that documents of title are not released from the investment business's control to clients, registrars, brokers, etc. without the records being amended;
 - (c) records kept in respect of any document clearly setting out the date of receipt and despatch of the document, the nature of the document, the client to whom the document relates, and the nature, amount and nominal value of the investment to which the document relates;
 - (d) evidence that statements are sent to clients at the required intervals, made up to the appropriate date, and properly specifying the documents held. In this context, the auditors may consider obtaining direct confirmation from clients;

- (e) evidence that correspondence from clients querying statements and any other queries have been dealt with properly and promptly; and
- (f) evidence that benefits such as dividends or scrip issues are collected and correctly allocated to each client.

Adequate systems and controls – Safekeeping and proper control of custody assets including the sending of periodic statements

Control objectives

- 17 The main factors that will be considered are:
- (a) satisfactory arrangements for ensuring the physical safe custody of documents;
 - (b) satisfactory arrangements for documents to be released only to the client, or to an eligible custodian, or to some other party upon the circumstances or under discretionary powers given in the client agreement;
 - (c) any independent custodian used by the investment business to be eligible to act in such a capacity;
 - (d) risk assessments to be carried out on all custodians to assess the risk of placing client assets with a third party;
 - (e) written arrangements between the investment business and the custodian covering at least the minimum requirements of the rules;
 - (f) written notifications to clients covering the notices and warnings required by the rules; and
 - (g) an adequate system to ensure that statements are sent to clients at required intervals, and that such statements properly reflect the investment business's records.

Evidence

- 18 The main factors that will be considered are:
- (a) a separate custodian area staffed by people independent of any other operations;
 - (b) qualifications and experience of managers;
 - (c) strong boxes, fire-proof rooms and safes, restricted access via password controlled doors or limited access to keys;
 - (d) the areas for receipt and despatch of documents being limited and strictly controlled;
 - (e) evidence of spot checks of the custodian area by the compliance or internal audit departments;

- (f) written procedures stating how custodian staff are to process the movement of documents and what is required in the form of authorisation;
- (g) evidence of procedures for selection of external custodians to ensure that they are eligible and suitable;
- (h) results of a risk assessment process including external information on credit rating, financial results etc. and internal information on customer service received;
- (i) letters of agreement with custodians stating the terms under which they are operating;
- (j) standard notifications to clients and controls to ensure all clients receive the required notifications and warnings;
- (k) file copies of statements sent to clients, which agree with the records; and
- (l) procedures and controls (e.g. completed checklist) to ensure that all clients receive a statement (where required).

Adequate systems and controls – Proper registration and segregation of custody assets

Control objectives

19 The main factors that will be considered are:

- (a) registerable safe custody investments registered in a name permitted by the rules;
- (b) where safe custody investments are registered in the same name as that used for the investment business's own investments, that the safe custody investments are registered in a designated account (or held physically as a separate certificate) different from that in which its own investments are registered;
- (c) for bearer documents of title, that the owner can be identified at all times and that it is readily apparent which investments relate to the investment business and which to the client;
- (d) investments held as security can be separately identified;
- (e) arrangements for releasing documents under stock lending arrangements are in accordance with the relevant rules; and
- (f) other assets held on behalf of clients are distinguishable from assets belonging to the investment business.

Evidence

20 The main factors that will be considered are:

- (a) written instructions from clients stating the manner in which their investments are to be registered; these instructions may be set out in standard client documents;
- (b) written procedures setting out how each document is to be identified so as to reflect the client's entitlement to that document (e.g. registered in the client's name);
- (c) where safe custody investments are registered in the name of a nominee company, that an appropriate record of the interests of individual clients is maintained;
- (d) clear segregation of client investment documents from other investment documents;
- (e) physical segregation of bearer securities held for clients from those belonging to the investment business and, where practicable, segregation among individual clients;
- (f) separate registers maintained of investments held as security;
- (g) evidence of appropriate authority to engage in stock lending arrangements, given to the business by the clients concerned;
- (h) separate records of all such transactions sufficient to show the details of the stocks lent at any time and the collateral held;
- (i) separate records of other assets held on behalf of clients.

Adequate systems and controls – Compliance with reconciliation requirements

- 21** The requirement to carry out reconciliations of custody assets and the recording of them occurs in the rules on both accounting records and systems and controls. The auditors test these reconciliations to ensure these requirements are satisfied.
- 22** Safe custody investments may be held in one or more of the following ways:
- (a) physically held as certificates by the investment business;
 - (b) held by a custodian appointed by the investment business; and/or
 - (c) dematerialised (e.g. CREST; uncertificated units in a collective investment scheme).

Control objectives – physically held safe custody investments

- 23** The main factors that will be considered are:
- (a) inventory counts and reconciliations of all securities performed with at least the frequency and in the manner required by the relevant rules, and by staff (in so far as possible) independent of the custodian department;
 - (b) procedures planned and implemented to ensure that the count of client title documents is accurate;
 - (c) timely clearance of reconciling items;

- (d) records retained of the dates and results of the inventory counts.

Evidence – physically held safe custody investments

24 The main factors that will be considered are:

- (a) detailed instructions for the counts;
- (b) an independent function (such as compliance department or internal audit) organising, controlling or participating in carrying out the counts and reconciliations;
- (c) sufficient time and resources devoted to the counts and reconciliations;
- (d) full and clear documentation of the counts and reconciliations;
- (e) counts carried out at the frequency and with the time limits required by the rules;
- (f) adequate explanations for reconciling items;
- (g) completion of reconciliations (i.e. all items explained) within time limits set out in the rules.

Control objectives – safe custody investments held by a custodian

25 The main factors that will be considered are:

- (a) reconciliations for all custodians performed with at least the frequency and in the manner required by the relevant rules;
- (b) timely clearance of reconciling items;
- (c) the reconciliations undertaken by a person who is not involved with the recording or movement of the assets, if the size of the investment business permits this segregation of duties;
- (d) records retained of the dates and results of reconciliations including confirmations from external custodians.

Evidence – safe custody investments held by a custodian

26 The main factors that will be considered are:

- (a) an independent function carrying out the reconciliations;
- (b) sufficient time and resources devoted to reconciliations;
- (c) full and clear documentation of the reconciliations;
- (d) reconciliations carried out at the frequency required by the rules;
- (e) adequate explanations for reconciling items;

- (f) completion of reconciliations (i.e. all items explained) within time limits set out in the rules.

Control objectives – dematerialised investments

- 27** The main factors that will be considered are:
- (a) reconciliations of all dematerialised investments performed with at least the frequency required by the relevant rules;
 - (b) timely clearance of reconciling items;
 - (c) the reconciliations undertaken by a person who is not involved with the recording or movement of the investments, if the size of the investment business permits this segregation of duties;
 - (d) records retained of the dates and results of the reconciliations, including third party confirmations.

Evidence – dematerialised investments

- 28** The main factors that will be considered are:
- (a) an independent function carrying out reconciliations;
 - (b) sufficient time and resources devoted to the reconciliations;
 - (c) full and clear documentation of the reconciliations;
 - (d) reconciliations completed at the frequency required by the rules;
 - (e) adequate explanations for reconciling items;
 - (f) completion of reconciliations (i.e. all items explained) within time limits set out in the rules.

Custody assets other than safe custody investments

- 29** CASS 2 requires investment businesses to apply the rules to those custody assets which are not safe custody investments in a manner appropriate to the nature and value of the custody assets concerned. This will involve consideration of appropriate reconciliation procedures.

Compliance with the rules at year end dates

- 30** The main factors that will be considered are:
- (a) registerable investments belonging to clients are registered in appropriate names;

- (b) documents of title held by the investment business are held in such a manner that it is readily apparent that they do not belong to the business;
 - (c) the owner of the investments can be identified;
 - (d) investments held as security can be separately identified;
 - (e) investments held outside the business itself are held by eligible custodians or dematerialised as permitted by the rules;
 - (f) the requisite arrangements with custodians have been agreed in writing;
 - (g) confirmations have been received from all eligible custodians of investments held by them.
- 31** Where custody assets are physically held by the investment business itself, the auditors may attend part or all of one of the physical counts of client title documents. In reaching a conclusion regarding the extent to which this is necessary, the auditors consider the strength of controls surrounding, and the independence of, the count, reconciliation, day to day processing and custody of client documents of title.
- 32** The auditors examine confirmations from independent custodians of documents of title held by them and third party records of dematerialised investments.
- 33** The auditors inspect correspondence and agreements with custodians in order to verify compliance with the appropriate rules.
- 34** In larger investment businesses, a rolling reconciliation basis of confirming client title documents (similar to a manufacturing company's system of perpetual stock-taking) is sometimes adopted. This is only permitted by the rules where the FSA has been provided with written confirmation from the investment business's auditors on the adequacy of the systems and controls over the rolling reconciliation process. In giving such a report, the auditors have regard both to the detailed rules in this area and also to the general considerations on the adequacy of systems and controls contained in this Practice Note. In particular, care will be taken to ensure that systems and controls are in place to prevent teeming and lading.

Collateral

- 35** The collateral rules apply where an investment business holds assets to secure a client's obligation in connection with designated investment business. The main factor that will be considered is that the investment business must keep proper records of such assets.

CLIENT MONEY

Introduction

- 36** Client money is defined for the purposes of CASS 1-5 as money of any currency which, in the course of carrying on designated investment business, an investment business holds in respect of any investment agreement entered into, or to be entered into, with or for a client or which an investment business treats as client money in accordance with the client money rules. For this purpose, 'holds' is defined to cover situations both where the firm receives money and where money it already holds is required to be treated as client money.
- 37** For the particular investment business, the auditors understand what may constitute client money. They consider all situations and transaction types that may be entered into by the investment business. Although the investment business may consider that a particular area is not covered by the rules relating to client money, the auditors are alert to situations where this is incorrect and the investment business is in breach of the rules as a result.

Types of client

- 38** The auditors will be aware that different types of client are identified in the rules and the way in which investment businesses must (or may) treat money received from them varies. Generally, all money received from private/retail customers must be treated as client money although the FSA rules provide for certain non-private customers, ('market counterparties' and 'intermediate customers') to agree to be 'opted out' of protection for non-MiFID business. The opt-out is not available in the MiFID chapters of CASS.
- 39** Another category of client identified in the rules is 'affiliated companies'. For MiFID and certain non-MiFID business, money received from companies within the same group should be treated in the same way as money from other clients.

Banks carrying out designated investment business

- 40** Although the client money rules apply to all authorised persons, their application to banks is limited in certain respects. However, it is incorrect to state that the client money rules do not apply to banks at all.
- 41** Where a bank holds the client money of its investment business clients in accounts with itself, it is acting in its capacity as the client's banker and is not considered to be holding client money under the FSA client money rules. If the money is passed outside the bank then the client money rules may apply. Further guidance is contained in the rules.

Client bank accounts

- 42** When an investment business holds or expects to hold client money then it must open one or more client bank accounts. These must generally be at an approved bank (as defined in the rules) in the UK or overseas. Certain disclosures may need to be made to and consent obtained from clients whose money is to be held in overseas accounts before their money is paid into such accounts.
- 43** Before a client bank account is opened the investment business should carry out a risk assessment on the bank. Ongoing risk assessment should be carried out while the bank continues to hold client money. This should include both external information such as financial statements, credit ratings etc and internal information such as customer service received from the bank in the administration of the account.
- 44** A client bank account can be a current or a deposit account at a bank or a deposit (but not a share) account at a building society. The rules require that such an account in the name of the investment business has a title which makes it clear that the money in the account does not belong to the business, for example by including the term 'client account' in its title. For non-MiFID business the bank must be given written notice that it is not entitled to exercise any right of set-off against any amount owing to it on any other account of the investment business and that the title of the account distinguishes it from any account containing money belonging to the investment business. The bank must acknowledge these terms in writing. In the case of an account opened in the UK, if the bank has failed to make the necessary acknowledgement within 20 business days, the money must be withdrawn and the account closed.
- 45** Separate client bank accounts may be used for different categories of client money. There are detailed rules relating to the operation of the categories of bank account and it is not within the scope of this Practice Note to explain them. The auditors will need to study the specific rules carefully.
- 46** The client money bank accounts should not contain money other than client money, except in certain specified circumstances. The main factor that will be considered will be that any money in the client bank account that is not client money does fall within one of the specified exemptions.
- 47** Under certain conditions, client money for MiFID business may be held in qualifying money market funds.

Planning the client money work

- 48** The auditors' work on client money will be planned in relation to the three reporting requirements. For client money, the main areas that need to be addressed by the auditors, to enable them to fulfil their reporting requirements, are:

- (a) adequate accounting records;
 - (b) adequate systems and controls as regards:
 - (i) proper holding of client money;
 - (ii) payment into and withdrawal from client bank accounts;
 - (iii) proper accounting for interest;
 - (iv) compliance with daily calculation and reconciliation requirements;
 - (c) compliance with the relevant rules at the year end date.
- 49** As with custody assets, the control objectives that the auditors would expect to see in a business holding client money, the evidence from which the auditors seek to draw reasonable conclusions, and the procedures they may perform are outlined below. They are only indicative and will not be applicable to all businesses holding client money, especially smaller ones.

Adequate accounting records

Control objectives

- 50** The main factors that will be considered are:
- (a) proper recording of movements of client money;
 - (b) interest credited in accordance with the rules;
 - (c) reconciliations carried out in accordance with the rules;
 - (d) appropriate titles are given to accounts.

Evidence

- 51** The main factors that will be considered are:
- (a) adequate details of the day to day entries of money paid into and out of the client bank accounts and individual client accounts including:
 - (i) dates of receipts and payments;
 - (ii) name of the client;
 - (iii) name of the person from whom money was received or to whom it was paid, if other than the client;
 - (iv) sub-ledgers with individual client accounts;
 - (v) evidence of designation from a client;

- (b) records of the interest earned on the client money bank accounts, the determination of the amount of interest payable to clients and the dates and amounts of interest paid to clients;
- (c) records maintained on a timely basis;
- (d) evidence that reconciliations have been carried out as required and reconciling items have been investigated and cleared promptly;
- (e) the records maintained comply with the detailed guidance given by the FSA;
- (f) to provide third party evidence of client balances (except settlement balances), the auditors may consider obtaining direct confirmation from clients; in practice, this may be conveniently combined with testing the accuracy of statements of their investments sent to clients.

Adequate systems and controls – Proper holding of client money

- 52** Client money held by investment businesses has to be held on trust for clients in one or more separate client bank accounts at an approved bank as defined in the rules.

Control objectives

- 53** The main factors that will be considered are:
- (a) bank accounts opened with ‘approved’ banks;
 - (b) appropriate and continuing risk assessments will be carried out on banks holding client money;
 - (c) client money is diversified where amounts are of sufficient size;
 - (d) bank accounts include ‘Client Account’, or similar words which make it clear that the money in the account does not belong to the investment business in their description;
 - (e) where designated client bank accounts are used, then these are identifiable as such and contain the word ‘designated’ in their title;
 - (f) appropriate written notifications, confirmations and agreements sent to and received from the banks;
 - (g) systems are adequate to identify all client money;
 - (h) systems are adequate to ensure that all client money and only client money is paid in (other than where it is specifically allowed by the rules) and withdrawals are made in compliance with the rules;

- (i) systems are adequate to ensure that all client money is paid in promptly; and no later than by close of business the next day, unless otherwise disposed of in accordance with the rules;
- (j) systems are adequate to ensure that the three day limit for 'delivery versus payment' transactions is adhered to;
- (k) (for MiFID business) any transfer of client money to qualifying money market funds is carried out in accordance with the rules.

Evidence

54 The main factors that will be considered are:

- (a) documentation of the procedures for opening new accounts;
- (b) an up to date list of all bank accounts which identifies those that are client bank accounts;
- (c) results of risk assessment process;
- (d) letters from banks agreeing to the required conditions;
- (e) evidence of the client's consent to holding any money overseas;
- (f) evidence that, where necessary, separate accounts are opened for the different categories of client money;
- (g) where necessary, written consent from clients for opting out or for other permitted exceptions relating to the handling of client money;
- (h) scrutiny of individual client ledger accounts to ensure that they are not overdrawn, or if overdrawn that 'topping up' is taking place as part of the investment business's internal reconciliation/daily client money calculation procedures.

Adequate systems and controls – Payment into and withdrawal from client bank accounts

Control objectives

55 The main factors that will be considered are:

- (a) all client money is paid within one business day into a client bank account (or within the extended time limit for special instances, such as collections by representatives and foreign dividends, as set out in the rules);
- (b) all withdrawals from client bank accounts are made only for prescribed purposes and in accordance with client mandates.

Evidence

56 The main factors that will be considered are:

- (a) clear internal instructions setting out the procedures to be followed in dealing with any potential client money;
- (b) suitable levels of staff (i.e. with the appropriate training and experience) responsible for establishing client money accounts and identifying client money within the investment business;
- (c) lodgements regularly and promptly made;
- (d) lodgements to client money accounts comprise client money only, except as otherwise permitted;
- (e) lodgements to non client money accounts do not include client money;
- (f) withdrawals properly authorised and for purposes approved by the rules.

Adequate systems and controls – Proper accounting for interest

57 For non-MiFID business private customers must be paid all of the interest earned on their client money balances unless the investment business notifies such customers in writing of the terms and frequency with which interest is to be paid or that no interest is to be paid. If no interest is payable to a private customer that fact must be separately identified in any agreement or notification.

Control objectives

58 The main factors that will be considered are:

- (a) where necessary, client approval properly obtained for use of the investment business's own interest provisions;
- (b) where applicable, interest paid on all money subject to interest calculations (whether or not the investment business has earned interest);
- (c) interest payments correctly calculated by reference to the appropriate terms.

Evidence

59 The main factors that will be considered are:

- (a) notification to clients of the interest method to be adopted, where required by the rules;
- (b) schedules showing how interest due to clients has been calculated (or equivalent computer processes);

- (c) interest credited to client accounts.

Adequate systems and controls – Compliance with daily calculation and reconciliation requirements

- 60** Investment businesses are required to reconcile their client money records with bank statements. For MiFID business, this is described as the 'external reconciliation'; for non-MiFID business, the 'reconciliation'.
- 61** Investment businesses are also required to perform calculations to check that the client money resources are at least equal to the client money requirement and to 'top up' (by transfer of their own funds) any shortfalls which arise (MiFID business 'internal reconciliation'; non-MiFID business 'daily calculation').

Control objectives

- 62** The main factors that will be considered are:
 - (a) the internal reconciliation/daily client money calculation is carried out in accordance with the rules;
 - (b) any shortfall is topped up or excess withdrawn;
 - (c) reconciliations of client money bank accounts with the relevant bank statements are carried out at the frequency and within the time limits set out in the rules;
 - (d) the reconciliations are properly prepared and adequate explanations given for reconciling items, which should be cleared without delay;
 - (e) records are retained of the dates and results of the prescribed reconciliations.

Evidence

- 63** The main factors that will be considered are:
 - (a) an up-to-date list of the accounts held that agrees with the accounts being reconciled;
 - (b) evidence of an independent preparation and review of these reconciliations and calculations;
 - (c) reconciliations and calculations being carried out regularly over the period under review;
 - (d) copies of instructions to banks to make transfers.

Unclaimed client money

- 64** Where client money is identified as due to a particular client but the investment business has not been able to pay the money to that client, the firm must continue to treat that money as client money unless it meets the conditions set out in the rules.

The main factor that will be considered is whether an investment business that ceases to treat allocated but unclaimed funds as client money has taken the steps set out in the rules.

Compliance with the rules at year end date

- 65** The rules seek to ensure that:
- (a) client money balances are lodged with an approved bank (as defined in the rules);
 - (b) the banks used have acknowledged the trust status of the client bank accounts;
 - (c) the client money resource is at least equal to the client money requirement;
 - (d) the required reconciliations have been carried out of bank balances and client records;
 - (e) reconciliation differences have been properly investigated and promptly cleared.
- 66** The auditors carry out normal audit tests on bank reconciliations in their audit of client money. Particular attention will be paid to reconciling items, ensuring that outstanding and uncleared items are properly identified and are duly cleared shortly after the reconciliation date. As part of their substantive testing, the auditors examine and where appropriate obtain direct confirmation of bank balances from each bank (or in the case of margined transaction money, each relevant clearing house and intermediate carrying broker) concerned at the relevant date.
- 67** The investment business should also reconcile its client money bank accounts as often as necessary (at least once every twenty five business days for non-MiFID business). Some investment business need to reconcile client money bank accounts daily if the volume of business is high.

NO CLIENT ASSETS

- 68** An auditor of an investment business is alert to situations where the business is not permitted under the terms of its authorisation to hold client assets or does not, as a matter of policy, hold client assets. Where this is the case, the investment business should have systems in place to identify and return any money or other assets it receives which are wholly or partly due to a client.

- 69** Where the auditor is required to give the FSA a statement of negative assurance that an investment business has not administered or held client assets, they consider carrying out the following procedures:
- (a) enquire as to what arrangements an investment business has in place to ensure that relevant staff are aware of what constitutes client assets. This could be documented in a procedural manual or internal memorandum and should outline the procedures to be followed if client assets are identified;
 - (b) enquire as to how settlements are effected on behalf of clients (references will be made to client documentation and payment instructions on contract notes or statements);
 - (c) review the cash book in order to confirm that receipts and payments in the cash book only relate to the investment business's own money and that no client money is being received or held;
 - (d) review the investment businesses client files to see whether they provide any indication that it has held client assets in order to undertake a particular transaction;
 - (e) review client agreements for statements of how custody is to be operated; as a corollary, review the agreements with any custodians used and the counterparty files (ie the documentation which supports the investment transactions) for correspondence on settlement procedures to ensure that there is no evidence that the investment business has offered client money protection (ie held separately in accordance with the rules);
 - (f) in the case of an investment business that does not act for private customers, review the client lists to ascertain that clients do not appear to belong to this category. (There must be proper documentation between the investment business and the client in accordance with the FSA's requirements to determine that the client money rules do not apply);
 - (g) enquire as to how dividends, especially unclaimed dividends, and rights issues are dealt with;
 - (h) ascertain whether a system of review exists to ensure that client assets are not administered or held. This could constitute periodic review by the internal auditors or compliance officer and encompass substantive review of the investment business's bank accounts and client agreements; and
 - (i) enquire as to details of any client money the investment business has received and the action taken.
- 70** The auditor considers obtaining a written representation from management that the investment business has not handled any client money or custody assets during the year.
- 71** The report the auditor makes to the FSA where an investment business does not hold client assets is included in Appendix 1.

APPENDIX 3**THE MAIN PARTS OF FSMA 2000 RELEVANT TO INVESTMENT BUSINESSES**

Part I (and Sch 1) sets out matters concerning structure and governance of the FSA including its regulatory objectives and the principles to be followed in meeting those objectives.

Part II (and Sch 2) sets out the general prohibition on conducting regulated business unless a person (including in a corporate sense) is either authorised or exempt, including restrictions on financial promotions. Regulated activities are defined in a statutory instrument. (SI 2001/544)

Part III (and Schs 3-5) sets out the requirements to become authorised either by receiving a specific permission from the FSA or through the EU single market rules. Exempt persons are listed in a separate statutory instrument. (SI 2001/1201)

Part IV (and Sch 6) sets out the arrangements for application for a permission to undertake authorised business and the criteria (Threshold Conditions) that must be met. An applicant who is refused can apply to the Financial Services and Markets Tribunal (established under Part IX).

Part V sets out the provisions applying to individuals performing designated functions (controlled functions) in an authorised firm. The FSA can specify controlled functions and firms must take reasonable care to ensure that only persons approved by the FSA can undertake these functions. The FSA can specify qualification, and training and competence requirements and approved persons must comply with the FSA's statement of principles and code of conduct for approved persons. Appeals can be made to the Tribunal.

Part VIII gives the FSA powers to impose penalties for market abuse – using information not generally available; creating a false or misleading impression; or, failure to observe normal standards. Abuse is judged from the point of view of a regular market user. FSA powers extend to all persons – not only authorised persons. The FSA is required to publish a code to give guidance on what is abuse and to provide a 'safe harbour'. This forms part of the Market Conduct Sourcebook and is called the Code of Market Conduct.

Part X provides the FSA with general powers to make rules which apply to authorised persons, including rules on specific matters – e.g. client money and money laundering. Rules must be published in draft for consultation. Guidance may be provided individually or generally and may be published. The FSA may modify rules or waive particular rules for particular persons in certain situations.

Part XI allows the FSA to gather information from authorised persons, including use of skilled persons' reports under section 166, or to commission investigations into authorised persons.

Part XIV sets out the disciplinary measures available to the FSA which can include public censure, unlimited fines, withdrawal of authorisation.

Part XXII includes the provisions relating to auditors and their appointment.

Part XXVI brings together in one place the arrangements applying to warning notices and decision notices concerning possible breaches of various requirements imposed by FSMA 2000 or by FSA rules. A warning notice has to state the reasons for proposed actions and allow reasonable time for representations to be made. This will be followed by a decision notice with a right to appeal to the Tribunal.

APPENDIX 4**THE FSA HANDBOOK**

- 1 Not all authorised firms are required to comply with all rules contained within the FSA Handbook. This varies with the type of permission – the regulated activity an authorised firm is permitted to undertake is set out in the authorised firm’s Scope of Permission. The following can be viewed on the FSA website:
 - contents of the FSA Handbook – www.fsa.gov.uk/Pages/handbook
 - the FSA Register which lists the regulated activities that each authorised firm has permission to undertake – www.fsa.gov.uk/Pages/register

- 2 In gaining an understanding of the Handbook the auditor bears in mind the four statutory objectives of the FSA, set out in paragraph 8 of the main text, which underpin the content of the FSA Handbook. To facilitate usage the FSA Handbook has been structured into a number of blocks and within each block the material has been sub-divided into sourcebooks or manuals. There are rules, evidential provisions⁴¹ and guidance which are contained within all of the blocks⁴². Contravention of rules (which includes Principles for Businesses) or evidential provisions can give rise to an obligation on the auditor to report the matter direct to the FSA – see the section of this Practice Note relating to ISA (UK and Ireland) 250 Section B. Outline details of certain elements of the FSA Handbook are set out below.

Principles for Businesses

- 3 The eleven Principles for Businesses, which are general statements that set out the fundamental obligations of firms under the regulatory system, are set out in the FSA Handbook. They derive their authority from the FSA’s rule-making powers as set out in the Act and reflect the regulatory objectives. These Principles are as follows:
 - an authorised firm must conduct its business with integrity;
 - an authorised firm must conduct its business with due skill, care and diligence;
 - an authorised firm must take reasonable care to organise and control its affairs responsibly and effectively with adequate risk management;

41 An evidential provision is not binding in its own right, but establishes a presumption of compliance or non-compliance with another rule. Guidance may be used to explain the implications of other provisions, to indicate possible means of compliance, or to recommend a particular course of action or arrangement.

42 Rules are set out in emboldened type and are marked with the icon ‘R’, evidential provisions are marked ‘E’ and guidance ‘G’. Further guidance on the status of the Handbook is set out in the General Provisions (GEN) Sourcebook Chapter 2.2 and Chapter 6 of the Reader’s Guide .

- an authorised firm must maintain adequate financial resources;
- an authorised firm must observe proper standards of market conduct;
- an authorised firm must pay due regard to the interests of its customers and treat them fairly;
- an authorised firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading;
- an authorised firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client;
- an authorised firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely on its judgement;
- an authorised firm must arrange adequate protection for clients' assets when it is responsible for them; and
- an authorised firm must deal with its regulators in an open and co-operative way, and must disclose to the FSA appropriately anything relating to the authorised firm of which the FSA would reasonably expect notice (see SUP15 – Notifications to the FSA).

Senior management arrangements, systems and controls

4 SYSC amplifies Principle for Businesses 3, the requirement for a firm to take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems. The relevant chapters^{43,44} for investment businesses are as follows;

- 2 – senior management arrangements
- 3 – systems and controls
- 4 – general organisational requirements
- 5 – employees, agents and other relevant persons
- 6 – compliance, internal audit and financial crime
- 7 – risk control
- 8 – outsourcing
- 9 – record keeping

43 From 1st November 2007, for common platform firms, SYSC Chapter 3 has been disappplied and replaced by SYSC Chapters 4-10 which form the common platform. The common platform comprises the combined systems and controls requirements of the CRD and MiFID. Firms subject to the common platform include those subject to the CRD or MiFID or both.

44 Chapters 3A and 13-17 apply only to insurers.

- 10 – conflicts of interest
- 11 – liquidity risk systems and controls
- 12 – group risk systems and control requirements
- 18 – guidance on Public Disclosure Act – whistle blowing.

Threshold Conditions

- 5 Under s 41 and Schedule 6 of FSMA 2000 Threshold Conditions are the minimum requirements that must be met at authorisation and must continue to be met. The five statutory Threshold Conditions are:
- legal status: investment business may be conducted by a body corporate, a partnership or a sole trader;
 - location of offices: a body corporate constituted under the law of the UK must have its head office and its registered office in the UK;
 - close links: close links must not prevent effective supervision. Entities are regarded as closely linked if there is a group relationship, i.e. parent/subsidiary/fellow subsidiary (but using the EC 7th Company Law Directive definition of subsidiary). They are also closely linked if one owns or controls 20% or more of the voting rights or capital of the other;
 - adequate resources: the authorised firm must have adequate resources (financial and non financial) for the type of business conducted taking into account the impact of other group entities and having regard to provisions made against liabilities (including contingent and future liabilities) and the approach to risk management; and
 - suitability: the FSA will consider the fitness and propriety of authorised firms, including whether business is conducted with integrity and in compliance with high standards, and whether there is competent and prudent management and exercise of due skill, care and diligence. This may include consideration of whether those subject to the approved persons regime (i.e. those undertaking controlled functions) are, or will be, approved by the FSA.

APPENDIX 5

REPORTING DIRECT TO THE FSA – STATUTORY RIGHT AND PROTECTION FOR DISCLOSURE UNDER GENERAL LAW

- 1 When the auditor concludes that a matter does not give rise to a statutory duty to report direct to the FSA, the auditor considers the right to report to the FSA.
- 2 In cases of doubt, general law provides protection for disclosing certain matters to a proper authority in the public interest.
- 3 Audit firms are protected from the risk of liability from breach of confidence or defamation under general law even when carrying out work which is not clearly undertaken in the capacity of auditor provided that:
 - in the case of breach of confidence:
 - (i) disclosure is made in the public interest; and
 - (ii) such disclosure is made to an appropriate body or person; and
 - (iii) there is no malice motivating the disclosure; and
 - in the case of defamation:
 - (i) the information disclosed was obtained in a proper capacity; and
 - (ii) there is no malice motivating the disclosure.
- 4 The same protection is given even if there is only a reasonable suspicion that non-compliance with law or regulations has occurred. Provided that it can be demonstrated that an audit firm, in disclosing a matter in the public interest, has acted reasonably and in good faith, it would not be held by the court to be in breach of duty to the institution even if, an investigation or prosecution having occurred, it were found that there had been no breach of law or regulation.
- 5 When reporting to proper authorities in the public interest, it is important that, in order to retain the protection of qualified privilege, auditors report only to one who has a proper interest to receive the information. The FSA is the proper authority in the case of an investment business.
- 6 'Public interest' is a concept which is not capable of general definition. Each situation must be considered individually. In general circumstances, matters to be taken into account when considering whether disclosure is justified in the public interest may include:

- the extent to which the suspected non-compliance with law or regulations is likely to affect members of the public;
 - whether the directors (or equivalent) have rectified the matter or are taking, or are likely to take, effective corrective action;
 - the extent to which non-disclosure is likely to enable the suspected non-compliance with law or regulations to recur with impunity;
 - the gravity of the matter;
 - whether there is a general management ethos within the entity of disregarding law or regulations;
 - the weight of evidence and the degree of the auditors' suspicion that there has been an instance of non-compliance with law or regulations.
- 7 Determination of where the balance of public interest lies requires careful consideration. The auditor needs to weigh the public interest in maintaining confidential client relationships against the public interest of disclosure to a proper authority and to use their professional judgement to determine whether their misgivings justify them in carrying the matter further or are too insubstantial to deserve report.
- 8 In cases where it is uncertain whether the statutory duty requires or s 342 or s 343 FSMA 2000 permits an auditor to communicate a matter to the FSA, it is possible that the auditor may be able to rely on the defence of disclosure in the public interest if it communicates a matter to the FSA which could properly be regarded as having material significance in conformity with the guidance in ISA (UK and Ireland) 250 Section B and this Practice Note, although the auditor may wish to seek legal advice in such circumstances.

APPENDIX 6

THE AUDITOR'S RIGHT AND DUTY TO REPORT TO THE FSA: EXAMPLES OF REPORTABLE ITEMS

Although there are a large number of 'relevant requirements' or matters of concern potentially giving rise to a statutory duty to report, these will normally fall within a number of general themes, which the auditor should be aware of:

- Controllers, directors and senior managers who may not be 'fit and proper';
- Serious breaches of law / regulations;
- Potential disciplinary action against the firm or directors;
- Undertaking activities outside the scope of their permission;
- Failure to comply with limitations or restrictions on permission or individual requirements;
- False or misleading information given to the FSA or matters concealed;
- Problems with another 'regulator' e.g. Office of Fair Trading (i.e. regards the Consumer Credit Act) or overseas regulators;
- Breaches of prudential limits and/or any financial limits;
- Significant actual or potential loss by clients e.g. loss of customer assets or breach of client money rules; where there appear to be conflicts of interest; where there appears to be systemic abuse of advice or discretionary decisions; or as identified by complaints or by cases where a customer sues under s150 FSMA;
- Failure to clearly allocate responsibilities between senior managers or to implement clear reporting lines;
- Major systems and control weaknesses (including major reconciliation failures and backlogs);
- Possible 'going-concern' issues.

The above general themes are intended as a guide – any report would need to be made against a specific relevant requirement. If an issue has been identified relating to one of the themes, (which might be materially significant to the FSA and is in a situation where the auditor is under a duty to report), the auditor should identify the relevant requirement. Even if a specific relevant requirement cannot be established, the auditor should consider whether or not the right to report is appropriate.

APPENDIX 7**AUDIT REPORTING REQUIREMENTS****Types of investment firm and the requirement for an auditor**

Firm type	Audit of annual accounts	SUP 3.10 audit
(1) BIPRU investment firm (including a UCITS investment firm and an exempt BIPRU commodities firm)		
Incorporated – not small	X	X
Incorporated – small	X	X
Unincorporated	(Note 1)	X (if there is a permission to hold client assets)
(2) Exempt CAD firm (Note 4)		
Incorporated – not small	X	X
Incorporated – small (Note 5)	X	X
Unincorporated		
(3) Securities and Futures firm		
Incorporated – not small	X	X
Incorporated – small	Note 2	X (if there is a permission to hold client assets)
Unincorporated		X (if there is a permission to hold client assets)

(4) Investment management firm		
Incorporated – not small	X	X
Incorporated – small	Note 2	X (if there is a permission to hold client assets)
Unincorporated		X (if there is a permission to hold client assets)
(5) Personal investment firm (not small)		
Incorporated – not small	X	X
Incorporated – small	Note 2	X (if there is a permission to hold client assets)
Unincorporated		X (if there is a permission to hold client assets)
(6) Small personal investment firm (Note 3)		
Incorporated – not small	X	
Incorporated – small	Note 2	
Unincorporated		
(7) UCITS firm		
Incorporated – not small	X	X
Incorporated – small	X	X

Other categories

For other categories of firm, such as authorised professional firms and service companies, readers should refer to the table in SUP 3.1.2R of the FSA Handbook.

Note 1

These firms are required by MiFID to have an audit of their annual accounts but only if they hold client assets.

Note 2

No statutory audit is required under CA 2006 for small companies with financial years ending on or after 31st December 2006. In short, the small companies audit exemption is available if the firm:

- (a) meets the Companies Act 2006 criteria for the small companies audit exemption; and
- (b) does not undertake any activity within the scope of MiFID, UCITS Directive, Banking Consolidation Directive or the Insurance Directives or is an e-money issuer.

Note 3

A small personal investment firm is one which:

- is not a MiFID investment firm;
- is not a network; and
- has fewer than 26 representatives.

Note 4

For the purposes of this table the terms securities and futures firm, investment management firm and personal investment firm have been taken not to include an exempt CAD firm.

Note 5

An exempt CAD firm that has opted into MiFID can benefit from the audit exemption for small companies in the CA 2006 if it fulfils the conditions of regulation 4C(3) of the FSMA 2000 (Markets in Financial Instruments) Regulations 2007. In other words, if such an exempt CAD firm continues to meet the conditions of the article 3 MiFID exemption (notwithstanding it is an exempt CAD), it can benefit from the small companies exemption.

DEFINITIONS

Abbreviations and frequently used terms in this Practice Note are set out below:

ARROW II	'Advanced Risk Responsive Operating frameWork'. The term used for FSA's risk assessment process – the application of risk based supervision. It is the mechanism through which the FSA evaluates the risk an authorised firm poses to its statutory objectives enabling it to allocate its resources appropriately and respond to the risks identified.
Auditors	Both auditors appointed under company legislation and, where appropriate, accountants appointed other than under company legislation to carry out work of an audit nature. Throughout this Practice Note, therefore, the term is used to indicate auditors of incorporated investment businesses appointed under company legislation or similar statutory provisions; and any other auditors or reporting accountants appointed to report on a routine basis on matters specified by the regulator. Specifically in the circumstances of reporting on client assets, the auditor is defined as someone meeting the criteria under SUP 3.4.2 (R) (eligible for appointment as an auditor under the Companies Act).
Authorised firm	An entity which has been granted one of more Part IV permissions by the FSA and so is authorised under FSMA 2000 to undertake regulated activities – an authorised person. Authorised firms include investment businesses.
Authorised person	Term used throughout FSMA 2000 and related statutory instruments to refer to an authorised firm – see above.
BIPRU	Prudential sourcebook for banks, building societies and investment firms.
CA1985	Companies Act 1985
Client assets	Assets covered by the FSA's custody rules, collateral rules and client money rules.
Client money	For the purposes of CASS 1-5, client money is defined as money of any currency which, in the course of carrying on designated investment business, an investment business holds in respect of any investment agreement entered into, or to be entered into, with or for a client or which an investment business treats as client money in accordance with the client money rules.

Closely linked entity	As defined in s343(8) FSMA 2000, an entity has close links with an authorised firm for this purpose if the entity is a: <ul style="list-style-type: none"> (a) Parent undertaking of an authorised firm; (b) Subsidiary undertaking of an authorised firm; (c) Parent undertaking of a subsidiary undertaking of an authorised firm; or (d) Subsidiary undertaking of a parent undertaking of an authorised firm
Conduct of business rules	Those rules, regulations or codes of practice of the FSA regarding the maintenance of adequate standards by investment businesses in their dealings with clients.
Custody assets	A designated investment held for or on behalf of a client or any other asset which is or may be held with a designated investment held for, or on behalf of, a client
Directors	Directors of a company or other body, the partners, proprietors, committee of management or trustees of other forms of enterprise or equivalent persons.
EEA	European Economic Area.
EU IFRS	International Financial Reporting Standards adopted by the European Union.
FRS	Financial Reporting Statements
FSA	The Financial Services Authority.
FSMA 2000	Financial Services and Markets Act 2000
ISD	Investment Services Directive (European Directive: 93/22/EEC).
JMLSG	Joint Money Laundering Steering Group
MiFID	Markets in Financial Instruments Directive
Material significance	A matter or group of matters is normally of material significance to a regulator's function when, due either to its nature or its potential financial impact, it is likely of itself to require investigation by the regulator
OEIC	Open Ended Investment Company

Passport	The authorisation for an entity incorporated in an EEA Member State which is established and authorised in that state ('home state') in relation to activities covered by the Single Market Directives to carry on those activities in other EEA Member States ('host states') by setting up branches, or by providing services on a cross-border basis, without obtaining separate authorisation in those states.
Part IV permission	A permission granted by FSA under Part IV FSMA 2000 permitting an authorised firm to carry on regulated activities as specified in the FSMA 2000 Regulated Activities Order SI 2001/544 as amended.
Principles for Businesses	FSA Handbook defined principles with which an authorised firm must comply. The 11 principles are included in a stand alone element of the high level Standards block of the FSA Handbook – PRIN.
Regulated activities	Activities as defined in the Regulated Activities Order SI 2001/544 as amended
Relevant requirement	In relation to the auditors' duty to report direct to the FSA – a requirement imposed by or under FSMA 2000 which relates to authorisation under FSMA 2000 or to the carrying on of any regulated activity. This includes not only requirements set out in relevant statutory instruments but also the FSA's rules (other than the Listing, prospectus and disclosure rules) including the Principles for businesses. The duty to report also covers any requirement imposed by or under any other Act the contravention of which constitutes an offence which the FSA has the power to prosecute under FSMA 2000.
Regulator	The FSA.
SOCA	Serious Organised Crime Agency
SUP	Supervision manual of the FSA Handbook.
SYSC	Senior management arrangements, systems and controls element of the High Level Standards block of the FSA handbook.
The 2001 Regulations	SI 2001/2587 – FSMA 2000 (Communications by Auditors) Regulations 2001

Those charged with governance ISAs (UK and Ireland) use the term 'those charged with governance' to describe the persons entrusted with the supervision, control and direction of an entity, who will normally be responsible for the quality of financial reporting, and the term 'management' to describe those persons who perform senior managerial functions. The FSA Handbook of Rules and Guidance (FSA Handbook) uses the term 'governing body' to describe collectively those charged with governance. In the context of this Practice Note, references to those charged with governance includes directors of investment businesses.

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