

August 2019

PROVIDING ASSURANCE ON CLIENT ASSETS TO THE FINANCIAL CONDUCT AUTHORITY

Feedback Statement & Impact Assessment

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8th Floor, 125 London Wall, London EC2Y 5AS

FEEDBACK STATEMENT AND IMPACT ASSESSMENT

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1 Executive Summary

1. This paper sets out the Financial Reporting Council's proposed revisions to the 2015 Standard, developed to support auditors providing assurance to the Financial Conduct Authority (FCA) in respect of Client Assets (hereinafter referred to as CASS Audits). These revisions are the result of our Post Implementation Review of the efficacy of these standard, a process which included a Call for Feedback in December 2018. In addition to the formal submissions received from our Call for Feedback, we have engaged in a process of ongoing outreach to a wide range of stakeholders, including investor representatives, and held a series of round table meetings to understand the issues which are of greatest concern to the sector.
2. When we issued the CASS Standard in 2015, it was a significant change for the sector. With the support of the FCA, audit moved from a process that was supported only by best practice guidance, to one where auditors have to comply with mandatory requirements and are supported in doing so through the provision of application guidance. At the time the Standard was developed, there had been a number of significant failings in the CASS regime that had not been identified or report by auditor and the standard was intended to address that.
3. Given the significant changes proposed, we committed to carry out a post implementation review within three years – both to get feedback from a broad range of stakeholders, and to ensure that the Standard will continue to support the FCA's regulatory objectives. When the review was launched, we were careful to say that respondents should focus their comments on the CASS Auditing Standard, and not the FCA's CASS rules which are not within the scope of the review. Nevertheless, some of the comments received are focused on the rules rather than the standard, and there is nothing we can do to the standard in respect of those comments. We have however shared them with the FCA.
4. In proposing changes to the standard, we take account of the FCA's needs as the sector regulator. While the standard has had a positive impact, the CASS audit market is a diverse one, in which the largest audit firms participate along with a large number of smaller providers. We know that it is important to the FCA that the standard becomes fully embedded in the sector and as a result, the changes that are proposed at this stage are not substantial. Rather, they are intended as a means of making the standard work more consistently and effectively, supported over time by some monitoring, and making use of an industry-led forum to support consistent market practice.
5. Key changes we are proposing include:
 - Updates to the Standard to reflect changes to regulation and the scope of the CASS regime since it was first issued in 2015;
 - Removal of duplicated work effort in the requirements to the standard;
 - Strengthening of reporting requirements to those changed with governance, and a greater focus on improving the value of that reporting to drive positive change in an audited entity. This includes the prioritisation of findings that are to be reported;
 - Specific recognition that in planning and performing the audit, there may be an overlap of assurance between the CASS audit, and other statutory audit work

where systems, governance or control system are in common. Recognition too that the audit will include the use of information technology which may provide a source of both risk and assurance;

- A focus on Large and Medium-sized CASS firms when requiring an engagement quality control review. Smaller CASS firm audits should be subject to a review where the risk of the engagement justifies one; and
 - A reduction in application material to avoid duplication with the requirements.
6. For the most part, the feedback from the consultation was positive – there was recognition that the quality of audit had improved since the standard was adopted, and that greater rigour in the audit process had also resulted in CASS entities being better prepared for audit as a result. The greater profile of CASS work had helped with reporting CASS issues to those charged with governance, and a number of entities spoke about the investments they had made in their systems and processes as a result. Audit firms have recruited considerable additional experienced resource to support their CASS work.
 7. However, this investment has come at a price. CASS entities have noted that audit costs have increased significantly, and they have asked us to look at whether there are ways to get more value out of CASS auditor reporting for those charged with governance. Many stakeholders also agreed with the proposal that the FRC should look to set up a monitoring regime for CASS audit work, allowing it to collect better insight and evidence into the actual quality of CASS work. That regime should look to operate without placing significant additional cost on the audit arrangements, and we will discuss this further with the FCA.
 8. We have also sought to balance two potentially conflicting requests from respondents – on the one hand to encourage greater professional judgment in CASS engagements rather than setting a purely prescriptive approach; but for the FRC to provide more application guidance to support consistent application of the standard. Our preference in this respect is to maintain the position that the FRC operates as a principles-based regulator, consistent with the way in which all of our standards and guidance have been developed. If there is a need for greater consistency of application, then the sector may want to consider whether it develops an industry-led stakeholder forum including CASS firms, CASS auditors, with input from regulators in an observer capacity.
 9. We recognise that in proposing changes to the Standard, the sector needs to have some time to adjust and to update material and training. However, as the proposals are not major changes to the audit regime, we believe that it should be possible to apply the new standard to the 2020 year-end audit cycle. We welcome feedback from stakeholders who think differently.
 10. Along with this Feedback Statement, we have issued a revised standard, which includes proposed changes in tracked form. We welcome feedback on the changes and the issues discussed in this document. **Feedback should be sent for the attention of Mark Babington, Acting Director of UK Auditing Standards and Competition by email to AAT@frc.org.uk by 5pm on Friday 27 September.**

2 Impact Assessment

11. The FRC is a principles-based regulator and is committed to issuing proportionate Standards and Guidance that support the provision of high-quality, independent audit. The requirements proposed in this Exposure Draft have been developed in response to feedback in the post implementation review, stakeholder outreach and an ongoing dialogue with the FCA.
12. In making these revisions we have had regard to the FRC's 'Principles for the development of Codes, Standards and Guidance which include:
 - there is a clearly defined issue relevant to the FRC's mission and responsibilities;
 - the change is the most appropriate way to address the issue;
 - one or more of the following conditions is met:
 - a change is necessary to comply or align with a legal requirement; or
 - a change is required in the light of developments in international standards or in legislation or regulation; or
 - the risks to the public interest of not acting are significant, for example, a risk of systemic and/or market failure; or
 - it is possible to eliminate or significantly simplify a current requirement; or
 - it is necessary to clarify a current requirement; or
 - it is possible to create significant additional benefits in the public interest; or
 - a change is necessary to underpin the effectiveness of the FRC's enforcement and disciplinary activities;
 - the anticipated benefits of the change outweigh the costs.
13. As the standard has been developed to support the FCA's policy objectives, we have not prepared a separate impact assessment of costs and benefits. However, we note the sensitivity of the industry to the fact that ultimately, they bear the costs of the audit regime. Given that we are proposing no changes to audit scope in this consultation and are exposing all of our proposals before they are finalised for feedback, any costs will be limited to the annual update and training round carried out by audit firms. As an indicator of costs, there are some 3,500 CASS audit engagements carried out each year, and we believe a one-off cost of an additional 2 hours of work effort in familiarisation per engagement, at a blended rate would mean additional estimated costs of £1.5 million for the sector. Benefits will continue to accrue from the further embedding of a standard that drives consistently high-quality audit in the sector.
14. The revisions we have proposed, and the benefits to stakeholder confidence from having a rigorous audit framework in place, in support of the FCA's regulatory objectives are significant but unquantifiable.

3 Analysis of Call for Feedback responses and detail of proposed revisions to the standards.

In the post implementation review consultation, we asked for feedback in respect of nine questions. In the following section of this paper, we set out an analysis of feedback for each question, and how we propose to respond in making any revisions to the standard.

We received 28 responses to the consultation – a significantly higher level of engagement compared to when the standard was adopted, which is a very positive development, and also reflects much greater willingness to discuss CASS audit issues.

The distribution of those responses was as follows:

- 11 responses came from audit firms and professional bodies;
- 13 responses from CASS firms and CASS advisors; and
- 4 responses from industry groups.

We also held three round table meetings, which provided valuable feedback from CASS firms, many of whom shared their experience of the audit regime and how it has changed as a result of having a standard. We were grateful to the FCA for joining each of the round tables as an observer.

Having considered the responses carefully, our proposed actions are set out in ***bold italic text*** below. Where we consider that proposals made by respondents are a matter for the FCA and the FCA Rulebook, then we have not proposed any response as it would be inappropriate for us to do so.

- i. Do you agree that the CASS Standard has been successful in delivering the objectives set out in Paragraph 9 of the Introduction to the Standard and replicated in the covering paper? Please explain your reasoning.

Many respondents agreed that the Standard has had a positive impact on the quality of audit done in the sector, and many commented favourably, in particular, about the specific focus in the standard on training for those involved in CASS work. The framework of mandatory requirements has helped in setting clearer expectations of CASS auditors, although there were some respondents who encouraged the provision of more guidance to ensure consistency of application across the sector as a whole. CASS firms subject to audit were consistent in their feedback that auditors should have a greater regard to risk when planning and performing their work, being cognizant of the fact that their work should be sufficient to support a reasonable assurance opinion, without over auditing.

Some respondents to the consultation, and attendees at our round tables made reference to feedback from the FCA, which suggests that although the Standard has driven improvements, it has yet to fully embed across the full population of CASS auditors, and in view of this it might be appropriate to delay significant change to the standard until fully embedded.

A small number of CASS firms raised concerns about their auditors being more focused on compliance with the rules, and identifying rule breaches, rather than basing their work on a clear understanding of the CASS risk in an entity. However, in our round table engagements, some CASS firms spoke very positively about their auditor experience – it was clear that where firms have invested in building their experience and capacity it has had a positive outcome on the CASS audit process.

Given the positive feedback, and the recognition that across the CASS audit market as a whole, there are areas where further embedding is required, we do not propose significant changes to the standard at this stage. The focus of any changes is to assist in the effective use of the standard, to clarify requirements, update references to regulation and remove duplication.

- ii. Do you agree that the enhanced independence requirements of the FRC Ethical Standard have been positive in underpinning user confidence in CASS audit? Please explain your reasoning.

Most respondents noted that this was beneficial to support stakeholder confidence in auditor independence, although this meant that especially in the case of the largest CASS firms they argued that it was inevitable that the CASS auditor would end up being the same audit firm as the statutory auditor, as to do anything else would limit choice in future tenders for the provision of audit services.

We do not propose to change the applicable independence requirements for CASS audits. The same requirements should apply to CASS audits as are applicable to a statutory audit. Auditor independence is important to support stakeholder confidence, and given the public interest focus of CASS we consider that the requirements in the ethical standard continue to be followed.

- iii. Do you believe that the quality of CASS audits has improved? If so, what are the indicators of this?

As noted in the analysis of responses to Question 1, there has been broad support for the standard and recognition that it has supported higher quality CASS audits. Many respondents pointed to a more rigorous engagement, with better and more senior challenge from auditors, supported by better communication between auditor and audited entity.

However, respondents, principally from CASS firms, have raised concerns that audit firms have focused rather more on the documentation of controls and rules mapping, rather than testing the underlying effectiveness of those controls to assess CASS risk and use that insight in the planning and performance of their audit. Others also called for auditors to take a more risk-focussed approach. Whilst we propose to take measures to enhance the auditor's risk assessment, we note that their work is necessarily focussed on compliance with the FCA's rules because that is the nature of the regulatory regime in place.

Respondents also referred to presentations at sector-related conferences which stated that since the adoption of the standard, auditors have identified more breaches and issued more modified opinions to the FCA.

The CASS audit will continue to be focused on the reported year-end position, and the operation of the control environment throughout the reporting period. However, we do recognise that it is important that auditors are able to demonstrate how their work is underpinned by a robust risk assessment, which considers the risks of an entity failing to comply with CASS rules, and ultimately risking client assets. We have updated the standard with proposals to strengthen this. We have also proposed measures to strengthen reporting between auditor and CASS entity.

- iv. Are there further steps that the FRC should consider including in the CASS Standard, to support the delivery of consistently high-quality CASS audits? Please set these out in your response.

Respondents made a number of proposals to provide additional guidance to the standard. Specific suggestions were enhanced material: covering the application of materiality; and the use of IT specialists in support of CASS audits. Audit firms also requested more guidance on the procedures that a CASS auditor should perform when considering the applicability of the CASS regime to a firm (although this is one of the initial requirements of the standard). Other audit firm respondents asked for guidance on how the CASS auditor could utilise the work of the SOC auditors engaged by third party administrators.

We also received a number of responses which asked for guidance on 'proportionality', particularly in respect of the scalability of audits to different types of entity.

We have considered the requests for more guidance on materiality carefully. The CASS rules are clear that materiality is not a consideration, as there is no materiality, and a breach is reportable regardless of its size. However, in planning and performing their audit, auditors need to give consideration to the extent of the work that is required to support a reasonable assurance opinion.

Fundamental to the application of the standard is the need for the CASS audit partner, and the CASS audit team to have a strong understanding and experience of the CASS rules. This is set out in the standard, along with a need for the team to have the necessary training to be able to carry out their role. We consider this requirement to mean that auditors in CASS engagements should have the skill and experience to understand the applicability of CASS to an entity, or it would call into question their ability to carry out their work in accordance with the standard. The use of IT specialists to support an audit engagement is therefore a matter for that audit firm, whilst remaining compliant with the overall requirements of the CASS standard.

- v. The standard requires the auditor to assess an entity's compliance with the FCA's CASS Rulebook. Are there any specific additional areas of guidance that should be developed to help in the assessment of whether custody relationships are fully compliant with the CASS Rulebook?

This question raised some interesting responses – auditors tend to be supportive of the development of more guidance, whereas the CASS industry itself considers that auditors should audit against the CASS rules, and if there is a need for additional material then that is a matter for the FCA.

The divergent views of the respondents reflect an inherent challenge in the development of principles-based guidance. All of the ethical and auditing standards developed by the FRC are principles based, and the CASS standard is no different. It would not be appropriate, therefore, to expand the standard with significantly more application material than would be found in ISAs (UK).

In a number of sectors, where there is a need for detailed guidance on the application of standards which cannot be incorporated into a principles-based standard, the FRC develops and issues Practice Notes which include best practice guidance on the application of requirements in a particular sector. The responses that we have received to the consultation suggest that there may be a need for additional guidance to support the application of the CASS standard rather than further changes to the standard. Whether that is FCA guidance, industry guidance or FRC guidance remains a matter of debate.

The FRC proposes limited changes to the standard as we do not consider that detailed additional guidance would fit within a principles-based standard. However, we are happy to hear from stakeholders ways of developing and providing application

guidance which might be needed to support more consistent market practice. This might include the mechanism discussed in the response to question ix.

- vi. Bearing in mind that a primary objective of the standard is to support the delivery of the FCA's objectives for the CASS regime, including the safeguarding of assets held, and preventing failure of the regime, would you propose any changes to the current standard, and if so, what would those changes be and why?

See summary of responses for Questions iv and v.

No additional observations.

- vii. Do you believe that there would be benefits from bringing CASS audits within the FRC's audit inspection and monitoring approach? How do you believe any such monitoring scheme should operate?

Stakeholders were, for the most part, supportive of our suggestion to put in place a monitoring agreement. This was intended to provide a mechanism for the FRC to be able to monitor CASS audit quality, and to practically test how well the standard is delivering its core objectives. Audit firms did, however, question how this proposal might align with Sir John Kingman's recommendations, and the setting up of a new statutory regulator in place of the FRC.

A number of CASS firms pointed to concerns about the increased cost of audit fees since the adoption of the standard, and urged that any monitoring regime should be proportionate, and as close to cost neutral as possible. Audit firm respondents also suggested that there would need to be a careful assessment of how to operate a regime which would provide a means of evaluating quality, but would recognise the number, and varying size of different providers of audit service in the sector. This would require close liaison between the FRC and Recognised Supervisory Bodies.

We recognise that a monitoring regime offers a means of collecting greater evidence about the quality of CASS audit work, and also provides a basis to make future enhancements to the standard. Monitoring of audit quality also ensures greater compliance with the framework, partly through deterrence. However, we agree the feedback that any such regime would need to be properly resourced, co-ordinated with the Recognised Supervisory Bodies, and cost effective. In order to determine whether this is feasible, we propose to work with the FCA to see if we can pilot a small number of CASS audit inspections as part of a feasibility study, to then see if a case can be made for a monitoring regime that will be proportionate, representative of the population of CASS auditors and deliver benefits in the form of improved quality.

- viii. Would you suggest any changes to the standard to increase the value of CASS audit to those entities that are subject to the regime? If so, what changes would you propose and why?

A number of respondents made suggestions to increase the scope of CASS work to cover some further elements of the CASS regime, with view to providing further assurance to the FCA and to those charged with governance.

Most respondents from CASS firms who provided responses focused on the need for reporting to also provide information that is useful to those charged with governance, in responding to and prioritising actions which respond to identified weaknesses in a firm's controls, systems and procedures.

Questions about the scope of CASS audit are matters for the FCA rather than the FRC.

The revision of the standard includes proposal to strengthen and prioritise better, reporting to those charged with governance. We have also proposed that CASS auditors should report to the FCA breaches they have identified as a result of their work. However, in respect of breaches identified by the CASS firm itself, the auditor should just report to confirm the completeness and accuracy of the breaches reported.

- ix. Are there any other matters that the FRC should take account of in carrying out this post implementation review? If there are, please set them out in your response.

A number of respondents were supportive of an industry-led forum, which would bring together CASS firms, auditors and sector regulators. This would offer a way of dealing with issues of interpretation and ensuring where possible common market practice. Such a proposal also attracted support in our outreach round tables and in CASS-related conferences and seminars.

The FRC believes that such an industry-led forum would be beneficial to resolving issues which give rise to market inconsistency, and which were raised in the round tables that we held. The FRC is happy to work with participants to establish such a forum with and participate in it if this proposal is taken forward.

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Financial Reporting Council

8th Floor
125 London Wall
London
EC2Y 5AS

+44 (0)20 7492 2300

www.frc.org.uk