



TECHNICAL RELEASE

AAF 01/06

ASSURANCE REPORTS ON INTERNAL CONTROLS OF SERVICE ORGANISATIONS MADE AVAILABLE TO THIRD PARTIES

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(revised))
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1. INTRODUCTION

1. Importance of outsourcing activities

1. Many entities use outside service organisations to accomplish tasks that affect the entity's internal controls. These services range from performing a specific task under the direction of the entity to replacing entire business units as functions of an entity. In recent years, there has been a significant increase in the use of service organisations, and because many of the functions performed are integral to the entity's business operations, the entity's management is concerned to ensure the control procedures at the service organisation complement those operated by their own organisation. In addition, because many of the functions performed by service organisations affect an entity's financial statements, auditors may also seek information about the control procedures surrounding those services.
2. The provision of outsourced services is particularly prevalent within financial service activities. The service organisations include custodians that hold and service assets, investment managers for securities and property, and organisations that provide software applications and a technology environment for the processing of transactions or accounting for pension schemes and investment funds. Accordingly, reporting accountants may be engaged by a service organisation to issue a report on specific control procedures undertaken by the service organisation which it may wish to make available to its customers ('customers') and the auditors of those customers. Reporting accountants are the accountants that perform an engagement for the service organisation. Customers are the clients of the service organisation using its services.

2. Need for new guidance

Since the original issue of FRAG 21/94, interest in reporting on internal controls among the investment communities has increased as a direct response to changes in the corporate governance environment and specific government initiated projects such as Paul Myners' report on investment practices. In order to provide information to these investment communities, thirdparty reporting using frameworks such as FRAG 21/94 has been widely applied as a means to increase external scrutiny of internal control processes.

Meanwhile, customers of service organisations have begun to focus on the need to replace the existing reporting framework that was last reviewed in 1997. Customers are increasingly seeking assurance on both the design and operating effectiveness of service organisations' control procedures. They are also seeking greater consistency between service organisations as to the scope and contents of their reports and greater transparency as to the extent of testing undertaken by reporting accountants.

These factors and comments on the use made of such reports on internal controls have led the Audit and Assurance Faculty of ICAEW to issue new reporting guidance¹. This guidance sets out the conditions service organisations meet in providing information on internal controls, control procedures and the framework within which reporting accountants deliver assurance reporting.

This guidance is specifically developed for a range of financial service activities, including:

- Custody;

¹ In conducting its work, the working group has included representatives from ICAEW, the National Association of Pension Funds, the Investment Management Association and service organisations.

- Investment management;
- Pension administration;

- Property management;
- Fund accounting; and
- Transfer agency.

To apply this guidance to other engagement circumstances involving activities such as payroll processing, additional considerations may be required.

The Audit and Assurance Faculty of ICAEW will keep the guidance under regular review to accommodate industry developments in relation to the control objectives set out in Appendix 1 and the range of activities set out in paragraph 6. Industry groups and other representative bodies or service organisations who wish to propose further service activities for inclusion within the guidance or to comment on the control objectives currently contained within Appendix 1 are encouraged to submit any such proposals in writing to the Audit and Assurance Faculty at tdaf@icaew.com.

Within the financial service activities listed above, it is anticipated that the control objectives include appropriate references to information technology.

It is for the directors of the service organisation to decide whether to prepare a report on their organisation's control procedures and whether to have this reported on by reporting accountants. In certain circumstances, directors may, for example, consider it more appropriate to allow access to customers and their auditors or provide a report on a specific aspect of its operations as this impacts an individual customer. It is not the intention of the guidance to oblige service organisations to report on control procedures in the manner described in this guidance. However, if the directors decide to provide a report other than in accordance with this guidance, they may not make any reference to this guidance in their report.

Where the directors decide to prepare a report on internal controls, it is of greater benefit to customers and their auditors if it covers control procedures in operation throughout a given period. However, a report on control procedures at a single point in time may be an alternative where a service organisation is preparing its report on internal controls for the first time². The guidance that follows generally assumes that the report covers a period.

A service organisation may have more than one type of financial service activity. In such a case, the directors explain to the reporting accountants the types of financial services the service organisation carries out at the outset of the engagement. The directors may prepare either a combined report or a separate report on each area of financial service activity as they deem appropriate. The reporting accountants report accordingly.

3. Scope

This Technical Release provides guidance to reporting accountants on undertaking an assurance engagement and providing a report ('assurance report') in relation to the internal controls of a service organisation.

² Where the directors and reporting accountants are reporting only on controls in place and not on their operating effectiveness during the specified period, this fact is clearly stated in the reports. The accountants modify their conclusions so as not to conclude on the operating effectiveness of control procedures during the specified period.

It is also expected to assist customers in understanding the scope and type of assurance conveyed in the assurance report. The guidance is also aimed at providing assistance to the directors of service organisations who prepare a report on their internal controls by clarifying their expected responsibilities.

This guidance replaces the Institute's guidance AUDIT 4/97 Reports on internal controls of investment custodians made available to third parties, FRAG 21/94 (Revised).

4. Transition from FRAG 21/94 (Revised)

The Technical Release is effective for periods ending on or after 31 March 2007. However, service organisations and reporting accountants are encouraged to apply this guidance before that date as best practice.

2. ASSURANCE ENGAGEMENTS

5. International developments

In 2004, the International Auditing and Assurance Standards Board (IAASB) published the International Framework for Assurance Engagements (the Framework) and the first International Standard on Assurance Engagements (ISAE) 3000, Assurance Engagements Other Than Audits or Reviews of Historical Financial Information. This standard was revised for assurance reports signed on or after 15 December 2015, and is now referred to as ISAE 3000 (revised). At the same time, a revised Framework was published. These pronouncements provide high-level principles for assurance engagements other than audits and reviews of historical financial statements.

The Framework defines the elements of assurance engagements and describes objectives for such engagements. ISAE 3000 provides generic guidance on the principal aspects of assurance engagements and refers to an assurance engagement involving three separate parties. Together these two international pronouncements provide the appropriate framework within which to develop specific guidance covering subject areas and topics such as internal control where, hitherto, no specific guidance has existed.

6. The types of assurance

There are two types of assurance engagements and associated objectives specified in the Framework: reasonable assurance engagements and limited assurance engagements.

In a reasonable assurance engagement, reporting accountants seek to obtain sufficient appropriate evidence that enables them to express a positive conclusion on the directors' report prepared for customers. In a limited assurance engagement, reporting accountants seek to gather evidence sufficient to obtain a meaningful level of assurance as the basis for a negative form of expression. This Technical Release is prepared for reporting accountants performing a reasonable assurance engagement.

7. Nature of engagement

The service organisation is responsible for providing information on specific control procedures ('control procedures') to meet the control objectives described in this guidance. The reporting accountants perform the engagement in accordance with this guidance. As discussed below the directors' and assurance reports may be made available to others, eg, pension scheme trustees or auditors.

The directors of the service organisation are responsible for preparing a report concerning the control procedures in place. The report is for the information of customers and their auditors and focuses on the operations which are likely to be relevant to them. It is therefore appropriate that any report provided by service organisations has regard to these relevant operations as well as those specified in this guidance.

The reporting package comprises a report by the directors of the service organisation concerning the control procedures of the service organisation and a reasonable assurance report by the reporting accountants, explaining the scope of work carried out and giving their conclusion on relevant parts of the directors' report. The conclusion is in the form of a qualitative judgement. The judgement and the report relate to historic matters.

8. Control objectives as criteria

Assurance engagements require reporting accountants to express an overall conclusion on the information assessed relative to certain criteria. Criteria also help the directors of a service organisation and their customers to understand how the reporting accountants have evaluated internal controls to reach their conclusion. In an assurance report on internal controls, the criteria are the control objectives around which the service organisation has designed its control procedures. The criteria need to be relevant, complete, reliable, neutral and understandable so as to communicate the basis of the evaluation.

The control objectives collectively reflect the level of control over customers' assets³ and related transactions set by the service organisation.

Appendix 1 sets out detailed control objectives for the financial service activities referred to in paragraph 6. These control objectives are guidance only and not intended to be exhaustive and it remains the responsibility of the directors to ensure that the described control objectives are sufficient to meet the expectations of customers. A service organisation may therefore consider the need to add further objectives and supporting control procedures where appropriate. If certain criteria do not apply to a service organisation, for example because the relevant activities are outsourced, the service organisation explains the omission of the criteria in the directors' report.

Reporting accountants consider the control objectives and observe supporting control procedures specified by the service organisation to form an overall opinion in the specific engagement circumstances at the time the work was undertaken. Reporting accountants also consider the linkage of the control procedures to the stated objectives and obtain sufficient appropriate evidence to reach their opinion. Through tests of control procedures, reporting accountants obtain sufficient appropriate evidence to conclude whether the relevant specified control objectives are met.

³ Reference may need to be made for liabilities, for instance for pension administration.

3. RESPONSIBILITIES OF A SERVICE ORGANISATION

9. The role of a service organisation The role of a service organisation in relation to the customers is likely to involve some combination of initiation, recording, processing, safeguarding or reporting the customers' assets and related transactions.

10. The responsibility of the directors

To meet the customers' expectations in terms of the level of control over customers' assets and related transactions, the directors of the service organisation identify control objectives together with the control procedures which they consider appropriate to enable these control objectives to be met. The key responsibilities of the directors in relation to these are summarised as:

- a) Acceptance of responsibility for internal controls;
- b) Evaluation of the effectiveness of the service organisation's control procedures using suitable criteria;
- c) Supporting their evaluation with sufficient evidence, including documentation; and
- d) Providing a written report of the effectiveness of the service organisation's control procedures for the relevant period.

(a) Acceptance of responsibility for internal controls

The directors are responsible for the design, implementation and operation of the control procedures of the service organisation. This is acknowledged in their report. It is also the responsibility of the directors to take reasonable steps to prevent and detect fraud.

Suitably designed control procedures, when complied with individually or in combination with other control procedures, are expected to operate so as to prevent or detect errors that could result in the failure to achieve specified control objectives. The directors also evaluate the design and operation of control procedures during the relevant reporting period. In this regard, the reporting accountants' tests are separate from the service organisation's own procedures for evaluating the effectiveness of the control procedures. The work of the reporting accountants cannot be used as part of the basis for the service organisation's assessment of whether control procedures are suitably designed or the operation of the control procedures is effective.

(b) Evaluation of the effectiveness of the service organisation's control procedures using suitable criteria

In order to evaluate the effectiveness of control procedures the directors refer to suitable criteria.

The control objectives in Appendix 1 are considered to be suitable criteria for the financial service activities specified in paragraph 6 of this guidance. The directors make a statement in their report that they have referred to the control objectives in this guidance. Most service organisations depend on computer processing to perform commissioned services and the service organisations' description of control procedures also includes a description of the computer environment and the related general computer control procedures. Suitable criteria relating to such information technology are also provided in Appendix 1.

(c) Supporting their evaluation with sufficient evidence, including documentation

The directors support their assertions with respect to the design, implementation and operating effectiveness of the service organisation's control procedures with sufficient evidence. The nature of

the directors' evaluation activities depends largely on the circumstances of the entity and the significance of particular controls but evaluation procedures include review and testing by internal audit, business risk and compliance review, direct testing by others under the direction of management or review by means of a self-assessment process. The directors consider the sufficiency of this evidence and whether any additional evaluation of specific areas or locations may be appropriate to enable them to provide a written assessment of the effectiveness of the internal controls. The process that the directors undertake includes considering:

- evidence available from on-going monitoring of control procedures;
- whether further control procedures are to be tested by them, including consideration of the locations or business units to include in the evaluation for an entity with multiple locations or business units;
- any deficiencies in control procedures that have come to their attention, for example, through management testing, internal audit reports and reports by regulators; and
- evaluation as to the likelihood that the failure of certain control procedures could result in a control objective not being met, the extent to which it might not be met and the degree to which other control procedures, if effective, achieve the same control objective.

Documentation of control procedures in place is in itself evidence of control procedures being identifiable, capable of being monitored and communicable to those responsible for their performance. Inadequate documentation may indicate a deficiency in the service organisation's control procedures and is subject to evaluation by the reporting accountants as to its significance (eg, it could be merely a deficiency, a material weakness or in extreme cases a limitation on the scope of the engagement).

Documentation of control procedures may take various forms depending on the nature and the type of the relevant information. For instance, policy manuals, process models, flowcharts and job descriptions could be used for recording the control procedure design, while documents and forms could be the record of operating and monitoring of control procedures.

The directors evaluate whether the documentation includes:

- the design of control procedures over all relevant control objectives;
- information about how significant transactions are initiated, authorised, recorded, processed and reported; and
- the results of management's testing and evaluation. Where the service organisation has introduced significant changes to its control procedures within the past 12 months, the control procedures before and after the change and the implications are documented. The judgement as to the significance of the change is based on its impact on the risk assessment of the customers and their auditors.

(d) Providing a written report of the effectiveness of the service organisation's control procedures for the relevant period

Through evaluation and documentation, the directors accumulate sufficient information to come to an overall conclusion as to the effectiveness of the service organisation's control procedures during a specified period. Their conclusion is based on the specified criteria, and includes an assessment of the impact of exceptions and deficiencies. The directors communicate the conclusion and the details of significant deficiencies to customers in their report. The following key matters are to be included in the report of the directors:

Contents of the directors' report

- (a) A statement of the directors' responsibilities.
- (b) The service organisation's control objectives, and a reference to the control objectives specified in this guidance, with details of any omitted or additional control objectives considered appropriate by the directors with explanations for such omissions and additions.
- (c) Aspects of the service organisation's control environment, risk assessment, management information, communication and monitoring process that may be relevant to the services provided.
- (d) Details of each of the specific control procedures designed to achieve the control objectives.
- (e) Reference to the use of this guidance.
- (f) Details of any significant changes to the control objectives and procedures during the period.
- (g) Details of any significant deficiencies and exceptions and their impact on the control objectives during the period.
- (h) A statement by the directors that they have assessed the effectiveness of the control procedures and their opinion that:
 - i. their report describes fairly the control procedures that relate to the control objectives referred to in (b) above which were in place as at [date];
 - ii. the control procedures described are suitably designed such that there is reasonable assurance that the specified control objectives would be achieved if the described control procedures were complied with satisfactorily [and customers applied the control procedures contemplated]; and
 - iii. the control procedures described were operating with sufficient effectiveness to provide reasonable assurance that the related control objectives were achieved during the specified period.
- (i) The name and signature of the director signing on behalf of the Board of Directors. (j) The directors' report date.

Example paragraphs from an illustrative directors' report on matters referred to at (a), (e), (h), and (i) above are set out at Appendix 2.

In applying the framework presented above, it is not necessary to list the control procedures and related control objectives in both the directors' report and in the assurance report.

The directors are responsible for the completeness, accuracy, validity and method of presentation of the description of control objectives and procedures. The description sets out information about the service organisation's control objectives and procedures that may be relevant to the customers. The reporting accountants may assist the service organisation in preparing the description; however, the representations in the description are the responsibility of the service organisation's directors.

The directors, where appropriate, seek to describe control procedures in a manner which permits verification and is understandable to customers. To achieve this and to promote consistency in approach, the directors may find it helpful to differentiate between the different components of the overall system which are being described in their report. The principal components are in general likely to include control objectives, control policies, process descriptions and control procedures. Process and control procedure descriptions in particular are factual and precise wherever possible in order to avoid the possibility of different interpretations being placed on these by different customers.

The description of control objectives and procedures does not necessarily address every service provided by the service organisation but presents a level of detail that provides sufficient information for customers to assess control risk and for the auditors of the customers to plan an audit of the customers' financial statements, as if a service organisation were not used.

11. Significant deficiencies

A control procedure deficiency (or a combination of control procedure deficiencies) is classified as a significant deficiency where, by itself or in combination with other control procedure deficiencies, it results in more than a remote likelihood that a control objective may not be met. Where such significant deficiencies are corrected during the year, customers may find it helpful to be informed of this in the directors' report.

12. Complementary control procedures of customers

The activities of the service organisation may be described with the assumption that customers have control procedures in place, with respect to such general matters as the authorisation of transactions, the written notification of changes, the timely review of reports provided by the service organisation, and appropriate restrictions on access to on-line terminals. If this is the case, the description of the control procedures at the service organisation refers to such required complementary control procedures of the customers.

13. Other responsibilities of the service organisation

Other responsibilities of the service organisation include:

- providing the reporting accountants with access to appropriate service organisation resources, such as service organisation personnel, systems documentation, contracts and minutes of management/audit committee meetings;
- disclosing to the reporting accountants any significant changes in control procedures that have occurred since the service organisation's last examination or within the last 12 months if the service organisation has not previously engaged reporting accountants to issue an assurance report;
- disclosing to the reporting accountants and the affected customers any illegal acts, fraud, or uncorrected errors attributable to the service organisation's management or employees that may affect its customers and the entity's whistle-blowing arrangements;
- disclosing to the reporting accountants any relevant design deficiencies in control procedures of which it is aware, including those for which the directors believe the cost of corrective action may exceed the benefits;
- disclosing to the reporting accountants all significant instances of which it is aware when control procedures have not operated with sufficient effectiveness to achieve the specified control objectives; and
- providing the reporting accountants with a letter of representation.

14. Service organisations that use other service organisations

Additional considerations are required where a service organisation uses another service organisation (a sub-service organisation) to perform certain aspects of the processing performed for the customers.

In addition to describing its control objectives and procedures, a service organisation that uses a sub-service organisation describes the functions and nature of the processing performed by the sub-service organisation in sufficient detail for the customers and their auditors to understand the

significance of the sub-service organisation's operations to the processing of the customers' transactions.

The purpose of the description of the functions and nature of the processing performed by the sub-service organisation is to alert the customers and their auditors to the fact that another entity is involved in the processing of the customers' transactions and to summarise the functions the sub-service organisation performs.

The service organisation determines whether its description of control procedures includes the relevant control procedures of the sub-service organisation. The two alternative methods of dealing with sub-service organisations are as follows:

The exclusive method: The sub-service organisation's relevant control objectives and procedures are excluded from the description and from the scope of the reporting accountants' engagement. The service organisation states in the description that the subservice organisation's control objectives and related procedures are omitted from the description and that the control objectives in the report include only the objectives which the service organisation's control procedures are intended to achieve.

The inclusive method: The sub-service organisation's relevant control procedures are included in the description and in the scope of the engagement. The description clearly differentiates between control procedures of the service organisation and control procedures of the sub-service organisation. The set of control objectives includes all of the control objectives which both the service organisation and the sub-service organisation are expected to achieve. To accomplish this, the service organisation coordinates the preparation and presentation of the description of control procedures with the sub-service organisation.

15. Other information provided by the service organisation

A service organisation may wish to present other information that is not a part of the description of internal controls in its report: for example, background information on the entities involved and the services they provide. Where information of this nature is presented, it is presented in a separate section of the report and made clear that it does not constitute a part of the service organisation's description of control objectives and control procedures.

4. GUIDANCE FOR REPORTING ACCOUNTANTS

16. Accepting an engagement

It is important that there is a clear understanding and agreement concerning the scope and purpose of the engagement between the reporting accountants and the service organisation and, if applicable, the customers that are party to the engagement (see paragraph 55).

Reporting accountants consider whether the engagement team collectively possesses the necessary professional competencies having regard to the nature of the assignment. As part of the engagement acceptance process reporting accountants also consider relevant ethical requirements.

In carrying out an assurance engagement, chartered accountants are subject to ethical guidance as laid down by the Institute in its ethical code. The requirements in the ethical code include, among other things, adherence to the Fundamental Principles in all of their professional and business activities as set out in the introduction. When conducting an assurance engagement, there are additional requirements in Independence for Assurance Engagements within the code. This applies to all

assurance engagements outside the scope of audit and is in compliance with the Code of Ethics established by the International Federation of Accountants (IFAC).

The reporting accountants' adherence to the independence requirements involves an assessment of likely threats to independence and, where necessary, the application of safeguards. For example, the provision of assistance to a service organisation in preparing its report may result in a self-review threat if the impact of the assistance on the matter being reported on is highly subjective and material. The subjectivity of the report proposed to be issued will also be relevant. If other than insignificant threats are identified, safeguards need to be considered. These might include:

- the use of independent teams, where appropriate; or
- an independent review of the key judgements on the engagement.

The assurance report may be received by a range of persons who are not party to the engagement. Reporting accountants do not intend to assume responsibility to persons who are not party to the engagement, but legal actions from such persons may nonetheless occur. Reporting accountants therefore need to apply appropriate engagement acceptance procedures in order to assess the risks associated with taking on a particular engagement and accordingly whether to do so and, if so, on what terms. Where the reporting accountants do accept such an engagement, suitably rigorous internal risk management policies are applied to manage any increased level of risk. Relevant steps for managing professional liability are covered in the following section⁴.

17. Managing professional liability

Depending on the engagement circumstances reporting accountants enter into one or a combination of the following arrangements:

- a) A tri-partite or multi-partite engagement contract with the service organisation and the customers, accepting that they owe a duty of care not only to the service organisation but also to those customers, including provisions limiting liability if appropriate (recognising that such a contract may not be achievable where the customers are numerous).
- b) An engagement with the service organisation with the facility for customers to enjoy a duty of care from the reporting accountants if they accept the relevant terms of the engagement letter previously agreed with the service organisation as if they had signed that letter when originally issued, including the same provisions limiting liability⁵.
- c) An engagement with the service organisation alone but before allowing the customers access to the assurance report, require the customers
 - i. to acknowledge in writing that the reporting accountants owe the customers no duty of care and
 - ii. to agree in writing that no claims may be brought against the reporting accountants by the customers in relation to the assurance report⁶.
- d) An engagement with the service organisation alone disclaiming any liability or duty to others (including customers) by notice in the assurance report. Reporting accountants also consider

⁴ Further guidance may be found in Statement 1.311, *Managing the professional liability of accountants* in the Institute's Members' Handbook.

⁵ This will require the consent of the service organisation/original addressees, ideally in the engagement letter.

Also see footnotes 18, page 34 and 21, page 35.

⁶ Reporting accountants may wish to have regard to the principles outlined in Audit 04/03 *Access to working papers by investigating accountants*, bearing in mind that Audit 04/03 addresses different circumstances relating to third party issues, when developing a written form of such acknowledgment and agreement.

supporting this disclaimer with an indemnity from the service organisation to apply where a third party claim is made (recognising that such an indemnity may not be attractive commercially, may not be effective if the service organisation is not financially stable, and may not operate to prevent a claim: see further paragraph 63 below)⁷. It is also open to reporting accountants to consider with their legal advisers the use of the Contract (Rights of Third Parties) Act 1999 to manage the risk of liability to third parties. The above arrangements do not prevent customers taking legal action against the service organisation.

Reporting accountants will describe carefully in their report the work that they do, including the description of the tests. In the latter context, close definition of what is meant by enquiry, inspection, observation and re-performance is desirable. Some illustrative definitions are set out at Appendix 7.

Reporting accountants disclaim responsibility and liability to customers' auditors, having regard to the responsibility of customers' auditors for their own audit reports and for determining to what extent (if any) the assurance report amounts to sufficient appropriate audit evidence for the purposes of their audit of a relevant customer's financial statements.

Reporting accountants may become aware of other third parties that are not customers of the service organisation, such as banks and other lenders or prospective purchasers of the service organisation, who may also request the assurance report. The service organisation or the third party may approach the reporting accountants for consent to make the assurance report available to such third parties, as the engagement contract agreed with the service organisation contains disclosure and use restrictions. The assurance report is not prepared for third parties or with their interests or needs in mind, and the reporting accountants may decline this request. The reporting accountants will have set out the purpose of their report in the assurance report, and will have included a disclaimer of liability to third parties in line with paragraph 55(d) above in that report. If the request is not declined, the reporting accountants will advise the third party that the assurance report was not prepared for the third party or the third party's benefit, that consent to their report being made available to a third party will only be given if the third party agrees that the third party should not rely on the report and acknowledges in writing that the reporting accountants owe the third party no duty of care and agrees that no claims may be brought against the reporting accountants by the third party in relation to the report.

Reporting accountants may also receive requests from the service organisation for consent to the release of the assurance report to potential customers with whom the service organisation may be exploring the possibility of a relationship, or reporting accountants may become aware that contrary to disclosure and use restrictions agreed with the service organisation in the engagement contract, such potential customers are gaining access to the assurance report. The reporting accountants may decline any such request. If the request is not declined, the written acknowledgement and agreement described above in relation to other third parties may be a practical solution to the management of risk in relation to potential customers. Where that is not practical, the reporting accountants require the service organisation (as a condition for giving consent, where requested) to send all such potential customers a written statement, to accompany the assurance report, pointing out that the reporting accountants did not undertake the work for potential customers and do not accept any responsibility to potential customers and deny liability to them. Reporting accountants may wish to provide the service organisation with a pro-forma statement and may wish to include reference to this in their engagement letter.

⁷ Reporting accountants consider the legal effectiveness of disclaiming liability and of the proposed disclaimer in light of the particular circumstances of their engagement (see for example, the guidance in Statement 1.311 on *Managing the professional liability of accountants*). Reporting accountants are advised to seek their own independent legal advice.

If correspondence between reporting accountants and customers, potential customers or third parties results from a disclaimer notice or otherwise, the reporting accountants decide (with independent legal advice if appropriate) how to bring such correspondence to a satisfactory close before it becomes protracted or undermines the original objective.

18. Agreeing on the terms of engagement

Prior to accepting the engagement, reporting accountants establish that the directors of the service organisation acknowledge in writing their responsibility on behalf of the organisation for the design and operation of effective internal controls over its activities to achieve control objectives.

Reporting accountants agree on the terms of engagement with the parties to the engagement in accordance with the contractual relationship as discussed in paragraph 55. To avoid misunderstandings, the agreed terms are recorded in writing in an engagement letter. Example extracts from an engagement letter for an assurance report on internal controls of a service organisation are given in Appendix 5 for illustrative purposes. Reporting accountants apply their own judgement to develop suitable wording for their engagement letters to reflect the guidance in this Technical Release and their own particular circumstances. Where the engaging parties include customers, the nature and the content of an engagement letter may differ from the example extracts.

The written terms of the reporting accountants' engagement include:

- the agreed use of the report and the extent to which, the context in which, and the basis on which, the report may be made available by the directors to customers and their auditors;
- the directors' and the reporting accountants' respective responsibilities for the different elements of the report;
- the scope of the work to be performed by the reporting accountants;
- a reference to the likely need for management representations;
- an explanation of the inherent limitations of the work, and for whom the work is being undertaken;
- limitations to the liability of the reporting accountants, including an appropriate liability cap; and
- provisions for an indemnity if considered appropriate⁸.

In particular, reporting accountants exclude liability in respect of any loss or damage caused by, or arising from fraudulent acts, misrepresentation, concealment of information or deliberate default on the part of the service organisation, its directors, employees or agents.

If, before the completion of the engagement, reporting accountants receive a request from the service organisation, to change an assurance engagement to a non-assurance or limited assurance engagement or to change, for instance, the scope of the engagement, the reporting accountants consider whether this has reasonable justification. Engagement parties' misunderstanding concerning the nature of the engagement or a change in circumstances that affects the customers' requirements is likely to justify such a request from the service organisation. Where accepting a request for a change, the reporting accountants do not disregard evidence that was already obtained prior to the change, and the details of the change should be documented and agreed in writing with the parties to the engagement letter.

⁸ It may be appropriate to obtain an indemnity from the service organisation in respect of claims from third parties arising from the contents of the assurance report. It must be remembered that an indemnity does not prevent a claim from being brought against the indemnified party. It merely gives him a right to pass on the liability to the indemnifier. It follows, therefore, that if the indemnity is in some way ineffective or the indemnifier does not have adequate resources to meet the liability, the indemnified party may be left unprotected.

19. Planning

Where reports are referred to as being prepared in accordance with the framework for reporting set out in this Technical Release, reporting accountants plan and perform their work so as to provide a reasonable basis for their conclusion. Professional judgement is needed to determine the required nature, timing and extent of the tests to be carried out and the reliance, if applicable, on the service organisation's internal audit department.

The reporting accountants' work is planned so as to have a reasonable expectation of detecting, at the time the work is undertaken, significant deficiencies in respect of the control procedures described by the directors and tested in accordance with the terms of the engagement. However, the work cannot be expected to detect problems which may be considered significant from the point of view of a particular customer and the scope of the work may mean that all control procedures relevant to an individual customer may not have been tested.

Reporting accountants are not expected to assess the adequacy of the evaluation of controls performed by the directors as part of an engagement to report on the entity's control procedures.

20. Reporting accountants' procedures

Fairness of the description

Reporting accountants read the description of control procedures to gain an understanding of the representations made by the directors in the description. After reading the description, the reporting accountants perform procedures to determine whether the description presents fairly, in all material respects, the service organisation's control procedures that relate to the control objectives referred to by the directors which were in place as at the end of the relevant period.

To determine whether the description is fairly presented, the reporting accountants gain an understanding of the services provided by the service organisation. Procedures to gain this understanding may include:

- discussing aspects of the control framework and relevant control procedures with management and other personnel of the service organisation;
- determining who the customers are and how the services provided by the service organisation are likely to affect the customers, for example, the predominant type of customers;
- reviewing standard terms of contracts with the customers to gain an understanding of the service organisation's contractual obligations;
- observing the procedures performed by the service organisation's personnel;
- reviewing the service organisation's policy and procedure manuals and other systems documentation, for example, flowcharts and narratives; and
- performing walk-throughs of selected transactions and control procedures.

Reporting accountants compare their understanding of the services provided to the customers by the service organisation with the directors' representations made in their report to determine the fairness of the description. Fairly described control procedures do not omit or distort significant information that may affect the customers' assessments of control risk.

Fairly described control procedures include a complete set of associated control objectives that are developed based on the criteria in Appendix 1. If there are omissions or misstatements with regard to the control objectives, the reporting accountants ask the directors to amend the description. If it is not amended the reporting accountants consider the need to state that fact in their report.

Design of control procedures

As a part of their work, reporting accountants determine whether the control procedures are suitably designed. A control procedure is suitably designed if individually, or in combination with other control procedures, it is likely to prevent or detect errors that could result in the nonachievement of specified control objectives when the described control procedures are complied with satisfactorily.

The reporting accountants' assessment of the suitability of control procedure design may include:

- considering the linkage between the control procedures and the associated control objectives;
- considering the ability of the control procedures to prevent or detect errors related to the control objectives;
- performing walk-throughs of selected transactions and control procedures; and
- performing further procedures, such as enquiry of appropriate entity personnel, inspection of documents and reports and observation of the application of specific control procedures, to determine whether they are suitably designed to achieve the
- specified control objectives and if they are operated as prescribed, by appropriately qualified or experienced persons.

Where certain control procedures of the service organisation are reliant on generic control procedures executed by the customers in order to achieve control objectives, reporting accountants consider whether such complementary control procedures are described in the directors' report. If they are not and the directors fail or refuse to amend the description, the reporting accountants consider adding an explanatory paragraph to describe the required complementary control procedures and consider the implication for the reporting accountants' conclusion on the fairness of the description (see paragraphs 85-90).

Operating effectiveness

Reporting accountants perform tests of the relevant control procedures to obtain evidence about the operating effectiveness of the control procedures during a specified reporting period. Operating effectiveness is concerned with how a control procedure is applied, the consistency with which it is applied, and by whom it is applied. Reporting accountants determine the nature, timing and extent of the tests to be performed to form their conclusion on the operating effectiveness of the control procedures. Reporting accountants may wish to provide the customers with a further explanation of the tests that they have performed in an appendix to their report.

Where reporting accountants are unable to test a described control procedure because, for example, it has not operated during the year, they state the fact that no tests have been carried out and the reason in their description of tests.

21. Nature, timing and extent of tests

Tests of control procedures over operating effectiveness might include a combination of enquiry of the appropriate personnel, observation of the application of the control procedure, inspection of relevant documentation and re-performance of the control procedure. Enquiry alone does not generally provide sufficient evidence to support a conclusion about the operating effectiveness of a specific control procedure.

The period of time over which reporting accountants perform tests of control procedures varies with the nature of the control procedures being tested and with the frequency of specific control procedures. Tests of operating effectiveness provide evidence that enables the reporting accountants to report on the entire period covered by the report. Certain control procedures may not have evidence of their operation that can be tested at a later date and accordingly, reporting accountants test the operating effectiveness of such control procedures at various times throughout the reporting period.

Where the service organisation implemented changes to its control procedures to improve them or to address deficiencies during the period covered, the reporting accountants evaluate the impact which the superseded control procedures had on the control objectives over the period covered. Where a change of control procedures occurs during the period, the reporting accountants agree with the directors whether it is possible for the control procedures to be tested before and after the change. The description of their tests clearly states which control procedures have been tested.

The number of control operations selected as a sample for testing depends on the frequency of performance (for example, quarterly, monthly, daily or multiple times a day), the nature (for example, manual or automated) of control procedures, and the reporting accountants' assessment of the system (including the risk of failure of the control procedure that is being tested). An example table for setting sample sizes is given in Appendix 6.

Describing tests of operating effectiveness and exception reporting

Reporting accountants describe the control procedures that were tested, the control objectives they were intended to achieve, the tests carried out and the results of the tests in the assurance report. This information is typically incorporated within the service organisation's description of control procedures or contained within an attachment to the assurance report. The reporting accountants describe tests of operating effectiveness that provide sufficient information to support their conclusion as to whether the service organisation has achieved the relevant control objectives during the period.

In describing the results of the tests, reporting accountants include details and other information where relevant to the customers and their auditors. Test results are also described whether or not the reporting accountants have concluded that the results constitute an exception (see paragraph 89).

Reporting accountants describe the nature, timing and extent of tests applied. In describing the nature of tests, the reporting accountants define the types of tests performed. Illustrative definitions of tests such as enquiry, inspection, observation and re-performance are provided in Appendix 7. In describing the extent of tests, the reporting accountants indicate whether the items tested represent a sample or all the items in the population. If sampling was used, it may be helpful to provide information on the sample size.

Reporting on description misstatements, design deficiencies or when control procedures are not operating effectively

Reporting accountants discuss with the directors when they become aware that the control objectives are incomplete or inappropriate in light of the criteria in this guidance so that the directors may amend the description to include the recommended control objective(s). If the directors refuse or fail to do so the reporting accountants add an explanation in the criteria and scope paragraph of the assurance report identifying the omitted or inappropriate control objective(s) to draw the attention of the customers and their auditors. In addition, the wording of the conclusion paragraph may also be modified. An example paragraph illustrating an exception to the fair description is provided in Appendix 4 (a).

Although reporting accountants may qualify their conclusion on the fairness of the description of control procedures, this does not necessarily affect the suitability of design or operating effectiveness of the control procedures because the reporting accountants' conclusion relates only to the control objectives that are included in the service organisation's description. Reporting accountants note that it is the responsibility of the directors and not the reporting accountants to ensure the completeness and the reasonableness of control procedures over the activities of the service organisation.

Where control procedures associated with stated control objectives are incomplete or inappropriate, reporting accountants also discuss this with the directors so that the directors may amend the

description to include the associated control procedures. If the directors refuse or fail to amend the description, the reporting accountants add an explanatory paragraph preceding the conclusion to the report identifying the omitted or inappropriate control procedures to draw the attention of the customers and their auditors. In addition, the wording of the conclusion paragraph may be modified. An example paragraph illustrating an exception to the fair description is provided in Appendix 4 (a).

Where reporting accountants conclude that a set of control procedures are not suitably designed in relation to a specified control objective, they consider the design deficiencies in their overall assessment of the control procedures. If the reporting accountants determine that control procedures are not suitably designed to achieve a specified control objective, they add an explanatory paragraph preceding the conclusion to the report identifying the design deficiencies and modify the conclusion. An example paragraph illustrating an exception to the suitability of design is provided in Appendix 4 (b).

Where the reporting accountants' tests identify exceptions to the operating effectiveness of the control procedures, the reporting accountants consider whether this exception means that a control objective has not been achieved. In some cases deficiencies may be so pervasive that the reporting accountants modify their conclusion on the achievement of one or more control objective or issue an adverse opinion. An example paragraph illustrating an exception to the operating effectiveness is provided in Appendix 4 (c).

Where significant changes are introduced during the period covered in the report, the directors report this fact. If reporting accountants become aware that the description on changes is missing, they request the directors to amend the description. However, the omission of information related to changes in the service organisation's control procedure does not warrant a qualification of the conclusion on the fairness of the description, provided that the directors' description of control procedures is fair as at the date of the description.

Elements of the service organisation report that are not covered by the assurance report

As discussed in paragraph 49 where the service organisation has included information other than that which constitutes a part of the description of control procedures in its report, this is outside the scope of the assurance report. The reporting accountants read such information for consistency with their understanding of the entity.

Elements of reporting accountants' assurance report

- a) A title indicating that the report is an assurance report.
- b) An addressee identifying the engaging parties to whom the assurance report is directed.
- c) Identification of the applicable engagement letter.
- d) Use of the report by the directors.
- e) Restrictions on the use of the assurance report to the directors [and customers party to the engagement] and the replication of the report in whole or in part.
- f) Limitation of the liability of the reporting accountants to the directors [and customers party to the engagement].
- g) An identification and description of the subject matter information.
- h) The identification of the directors as the responsible party and the respective responsibilities of the directors and the reporting accountants.
- i) Reference to ISAE 3000.
- j) Criteria against which control procedures were evaluated.

- k) A summary of the work performed.
- l) Inherent limitations associated with the evaluation/measurement of the subject matter against the criteria.
- m) The reporting accountants' conclusion with the description of the reporting accountants' findings including sufficient details of errors and exceptions found.
- n) The name and signature of the firm/reporting accountants and the location of the office performing the engagement.
- o) The assurance report date.

22. Assurance report

The reporting accountants' conclusion is expressed in a written report attached to the directors' report. The title of the report includes the term 'assurance' to distinguish it from non- assurance engagements, for instance, agreed upon procedures engagements. The report draws the attention of the readers to the basis of the reporting accountants' work, ie, ISAE 3000 and this guidance.

The report by the reporting accountants reflects the agreement set out in the engagement letter. The report makes clear for whom it is prepared and who is entitled to rely upon it and for what purpose as established in paragraphs 55 to 60.

Reporting accountants conclude on the fairness of the description and the design and operating effectiveness of control procedures in relation to a specified reporting period.

Control procedures have inherent limitations and accordingly errors and irregularities may occur and not be detected. Also control procedures cannot guarantee protection against fraudulent collusion especially on the part of those holding positions of authority or trust. Reporting accountants refer to such inherent limitations in their report.

Key elements of the assurance report are shown in the table below. Pro-forma reports on the internal controls over custodial operations are available in Appendix 3 (i) and (ii).

The engagement letter confirms that the assurance report is not to be recited or referred to in whole or in part in any other published document. This may also be stated in the report.

23. Using the work of internal auditors

A service organisation may have an internal audit department that performs tests of control procedures as part of its audit plan. The reporting accountants may determine that it might be effective and efficient to use the results of testing performed by internal auditors to alter the nature, timing or extent of the work they might otherwise have performed in forming their conclusion. Where using the work of internal auditors, however, the reporting accountants perform sufficient testing themselves which provides the principal evidence for their conclusion. The reporting accountants also make reference to the work of internal auditors in their report and attribute the performance of the tests and the results of tests to them where appropriate.

24. Considerations for uncorrected errors, fraud or illegal acts

In the course of performing procedures at a service organisation, reporting accountants may become aware of uncorrected errors, fraud or illegal acts attributable to the service organisation's systems, management or employees that may affect one or more customers.

Unless clearly inconsequential, reporting accountants determine from the directors of the service organisation whether this information has been communicated to the affected customers. If the directors of the service organisation have not communicated this information and are unwilling to do so, the reporting accountants inform the service organisation's audit committee or other group of directors with equivalent authority. If the audit committee does not respond appropriately, the reporting accountants consider whether to resign from the engagement. The reporting accountants are generally not required to confirm with the customers that the service organisation has communicated such information.

25. Management representation letter

In all engagements, reporting accountants obtain written representations signed by the directors of the service organisation who the reporting accountants believe are responsible for and knowledgeable, directly or through others in the service organisation, about the matters covered in the representations. The refusal by the directors of the service organisation to provide the written representations considered necessary by the reporting accountants constitutes a limitation on the scope of the engagement and may be considered in forming the reporting accountants' conclusion.

The representation letter is normally dated on the day the directors' report is dated.

APPENDICES

1. Control objectives

This section sets out detailed control objectives for the financial service activities referred to in paragraph 6. These control objectives are for guidance only and are not intended to be exhaustive, and it remains the responsibility of the directors to ensure that the described control objectives are sufficient to meet the expectations of customers.

Control objectives (h) – (j) have been added and conforming changes were made to (b) and (e) in June 2009.

(i) Custody

Accepting clients

- Accounts are set up and administered in accordance with client agreements and applicable regulations
- Complete and authorised client agreements are operative prior to initiating custody activity
- Investment holdings transferred from prior custodians are received and recorded completely, accurately and on a timely basis
- Client take-ons are monitored, documented and accurately reported to clients

Authorising and processing transactions

- Investment and related cash and foreign exchange transactions are authorised and recorded completely, accurately and on a timely basis
- Investment and related cash and foreign exchange transactions are settled and failures are resolved in a timely manner
- Corporate actions and voting instructions are identified, processed and recorded on a timely basis
- Cash receipts and payments are authorised, processed and recorded completely, accurately and on a timely basis
- Lender and borrower participation in lending programs is authorised and loan initiation, maintenance and termination are accurate and timely
- Loans are fully collateralised and the collateral together with its related income is recorded completely, accurately and on a timely basis

Maintaining financial and other records

- Investment income and related tax reclaims are collected and recorded accurately and on a timely basis
- Investments are valued using current prices obtained from independent external pricing sources and portfolio valuations are complete and distributed on a timely basis
- Asset positions for securities held by third parties such as sub custodians and depositories are accurately recorded and regularly reconciled

Safeguarding assets

- Physically held securities are safeguarded from loss, misappropriation and unauthorised use

Monitoring compliance

- Sub-custodians are approved and performance standards are monitored on a timely basis
- Outsourced activities are properly managed and monitored
- Transaction errors are rectified promptly and clients treated fairly

Reporting

- Client reporting in respect of client asset holdings is complete and accurate and provided within required timescales
- Asset positions and details of securities lent are reported to interested parties accurately and within the required time scale, including those responsible for initiating voting instructions, accurately and within required timescales

Information technology

See Appendix 1 (g)

(ii) Investment management – illustrative control objectives

Accepting clients

- Accounts are set up and administered in accordance with client agreements and applicable regulations
- Complete and authorised client agreements are operative prior to initiating investment activity
- Client take-ons, including in-specie transfers, are monitored, documented and opening positions are accurately reported to clients
- Investment limits and restrictions are established
- In-house pooled fund unitholder activity is recorded completely, accurately and in a timely manner
- Responsibility for generating proxy voting instructions is clearly established

Authorising and processing transactions

- Investment strategy is set and implemented in a timely manner
- Investment transactions are properly authorised, executed and allocated in a timely and accurate manner
- Transactions are undertaken only with approved counterparties
- Commission levels and transaction costs are monitored
- Investment and related cash transactions are completely and accurately recorded and communicated for settlement in a timely manner
- Corporate actions are processed and recorded accurately and in a timely manner
- Proxy voting instructions are generated and recorded and carried out accurately and in a timely manner
- Client new monies and withdrawals are processed and recorded completely and accurately; withdrawals are appropriately authorised

Maintaining financial and other records

- Investment income and related tax are accurately recorded in the proper period
- Investments are valued using current prices obtained from independent external pricing sources or determined according to approved pricing policies and procedures for fair values in circumstances where independent sources are not available
- Cash and investment positions are completely and accurately recorded and reconciled to third party data
- Investment management fees and other account expenses are accurately calculated and recorded
- Pooled funds are priced and administered accurately and in a timely manner

Cash management and segregation of assets

- Uninvested cash is managed with regard to diversification of risk and security of funds
- Investments are properly registered and client money is segregated

Monitoring compliance

- Client portfolios are managed in accordance with investment objectives, monitored for compliance with investment limits and restrictions and performance is measured
- Outsourced activities are properly managed and monitored and conflicts of interest identified to clients

- Transaction errors (including guideline breaches) are rectified promptly and clients treated fairly ☐
Counterparty exposures are monitored.

Reporting to clients

- ☐ Client reporting in respect of portfolio transactions, holdings and performance, commission and voting is complete and accurate and provided within required timescales

Information technology

See Appendix 1 (g)

(iii) Pension administration

Accepting clients

- Accounts are set up and administered in accordance with client agreements and applicable regulations
- Complete and authorised client agreements are operative prior to initiating administration activity
- Pension schemes taken on are properly established in the system in accordance with the scheme rules and individual elections

Authorising and processing transactions

- Contributions to defined contribution plans, defined benefit schemes, or both, and transfers of members' funds between investment options are processed accurately and in a timely manner
- Benefits payable and transfer values are calculated in accordance with scheme rules and relevant legislation and are paid on a timely basis

Maintaining financial and other records

- Member records consist of up to date and accurate information and are updated and reconciled regularly
- Contributions and benefit payments are completely and accurately recorded in the proper period
- Investment transactions, balances and related income are completely and accurately recorded in the proper period
- Scheme documents (deeds, policies, contracts, booklets etc) are complete, up to date and securely held

Safeguarding assets

- Member and scheme data is appropriately stored to ensure security and protection from unauthorised use
- Cash is safeguarded and payments are suitably authorised and controlled

Monitoring compliance

- Contributions are received in accordance with scheme rules and relevant legislation
- Services provided to pension schemes are in line with service level agreements
 - Transaction errors are rectified promptly and clients treated fairly.

Reporting to clients

- Periodic reports to participants and scheme sponsors are accurate and complete and provided within required timescales
- Annual reports and accounts are prepared in accordance with applicable law and regulations
- Regulatory reports are made if necessary

Information technology

See Appendix 1 (g)

(iv) Property management

Accepting clients

- Accounts are set up and administered in accordance with client agreements and applicable regulations
- Complete and authorised client agreements are operative prior to initiating investment activity
- Client take-ons are monitored, documented and accurately reported to clients
- Investment guidelines and restrictions are established
- Pooled fund unitholder activity is recorded completely, accurately and in a timely manner

Authorising and processing transactions

- Investment decisions are properly formulated in accordance with investment guidelines, authorised, implemented and reviewed on a timely basis
- Property developments are only undertaken in accordance with acceptable risk criteria
- Costs associated with buying and selling properties are authorised and recorded accurately
- Tenants' covenants and lease conditions are assessed and authorised on a timely basis
- Property and related cash transactions are completely and accurately recorded and settled in a timely manner
- Rental income and service charges are accurately calculated and recorded on a timely basis
- Client new monies and withdrawals are authorised, processed and recorded completely and accurately

Maintaining financial and other records

- Complete and accurate records of each property are maintained
- Valuations are obtained at regular intervals from independent external valuers
- Income entitlements are received in full, wherever possible, and expenses, both recoverable and irrecoverable, are controlled
- Property management fees and other account expenses are accurately calculated and recorded
- Rents are monitored and rent reviews are recorded promptly and accurately
- Pooled funds are priced and administered accurately and in a timely manner

Safeguarding assets

- Properties purchased are of good and marketable title
- Title deeds are safeguarded from loss, misappropriation and unauthorised use
- Uninvested cash is managed with due regard to diversification of risk and security of funds
- Risks arising from investing in property are insured where this is economic to the interests of owners (for example consider claims etc arising from the public where large shopping malls are owned)

Monitoring compliance

- Client portfolios are managed in accordance with investment objectives, monitored for compliance with investment guidelines and restrictions and performance is measured
- Outsourced activities are properly managed and monitored
- Transaction errors (including guideline breaches) are rectified promptly and clients treated fairly

Reporting to clients

- Client reporting in respect of property transactions, holdings and performance is complete and accurate and provided within required timescales

Information technology

See Appendix 1 (g)

(v) Fund accounting – illustrative control objectives (Revised June 2009)

Accepting clients

- Accounts are set up and administered in accordance with client agreements and applicable regulations
- Complete and authorised client agreements are operative prior to initiating accounting activity
- Client take-ons are monitored, documented and accurately reported to clients

Authorising and processing transactions

- Investment and related cash transactions are completely and accurately recorded in a timely manner
- Corporate actions are processed and recorded accurately and on a timely basis

Maintaining financial and other records

- Investment income and related tax are accurately calculated and recorded on a timely basis
- Investments are valued using current prices obtained from independent external pricing sources or determined according to approved pricing policies and procedures for fair values in circumstances where independent sources are not available
- Cash and investments positions are completely and accurately recorded and reconciled to third party data
- Expenses are accurately calculated and recorded in accordance with the requirements of the fund and on a timely basis
- Distribution rates are accurately calculated and authorised and distribution amounts are recorded in a timely manner
- Issues and cancellations of shares/units are recorded completely and accurately, and positions are regularly reconciled
- Fund pricing is accurate and timely

Monitoring compliance

- Outsourced activities are properly managed and monitored and conflicts of interest identified to clients
- Pricing and distribution rate errors are rectified in a timely manner.

Reporting to clients

- Net asset value is accurately calculated and reported in a timely manner
- Periodic reports to fund sponsors are accurate and complete and distributed on a timely basis
- Annual and interim reports and accounts are prepared having regard to disclosure requirements and submitted in accordance with timescales determined by applicable law and regulations

Information technology

See Appendix 1 (g)

Transfer agency

Accepting clients

- Accounts are set up and administered in accordance with client agreements and applicable regulations
- Adherence to subscription limits is checked and recording of client information required by legislation is accurate
- Complete and authorised client agreements are operative prior to initiating accounting activity
- Client take-ons are monitored, documented and accurately reported to clients

Authorising and processing transactions

- Documents received are checked, sorted and distributed for processing in a timely manner
- Investor transactions and adjustments are authorised, processed accurately, completely and in a timely manner
- Cash receipts are processed accurately and banked promptly
- Cheques and certificates issued are accurately generated, matched and authorised prior to despatch
- Fund distributions and related tax withholdings are accurately calculated and authorised and distributed in a timely manner

Maintaining financial and other records

- Transfer agent records accurately reflect securities and cash held by third parties
- Share/unit activity is recorded completely, accurately and positions are regularly reconciled

Safeguarding assets

- Lost and stolen certificates are recorded in a timely manner

Monitoring compliance

- Transaction errors are rectified promptly and clients treated fairly

Reporting to clients

- Compensation payments are authorised, calculated and reviewed by management
- Client reporting is complete and accurate and processed within required timescales

Information technology

See Appendix 1 (g)

(vii) Information technology

Restricting access to systems and data

- Physical access to computer networks, equipment, storage media and program documentation is restricted to authorised individuals
- Logical access to computer systems, programs, master data, transaction data and parameters, including access by administrators to applications, databases, systems and networks, is restricted to authorised individuals via information security tools and techniques
- Segregation of incompatible duties is defined, implemented and enforced by logical security controls in accordance with job roles

Providing integrity and resilience to the information processing environment, commensurate with the value of the information held, information processing performed and external threats

- IT processing is authorised and scheduled appropriately and exceptions are identified and resolved in a timely manner
- Data transmissions between the service organisation and its counterparties are complete, accurate, timely and secure
- Appropriate measures are implemented to counter the threat from malicious electronic attack (eg, firewalls, anti-virus etc.)
- The physical IT equipment is maintained in a controlled environment

Maintaining and developing systems hardware and software

- Development and implementation of new systems, applications and software, and changes to existing systems, applications and software, are authorised, tested, approved and implemented
- Data migration or modification is authorised, tested and, once performed, reconciled back to the source data

Recovering from processing interruptions

- Data and systems are backed up regularly, retained offsite and regularly tested for recoverability
- IT hardware and software issues are monitored and resolved in a timely manner
- Business and information systems recovery plans are documented, approved, tested and maintained

Monitoring compliance

- Outsourced activities are properly managed and monitored

Private equity – illustrative control objectives

Accepting clients

- New funds are properly developed and authorised, take account of legal and tax requirements and contain a specified investment strategy
- Prospective investors are assessed for suitability and complete relevant legal documentation prior to investment activity
- Investment guidelines and restrictions are established and updated as required

Authorising and processing investment transactions

- Investment decisions are researched, authorised and implemented in accordance with the investment strategy and due diligence and abort costs are controlled
- Investment transactions and commitments are properly authorised and executed in a timely and accurate manner (this is intended to include acquisitions and exits)
- Investment and related cash transactions are completely and accurately recorded and communicated for settlement in a timely manner
- Rights and obligation arising from an exit are recorded and monitored
- Investment allocations are made in accordance with the terms of the partnership or supporting agreements

(viii)

Maintaining financial and other records

- Investment income and related tax are accurately recorded in the proper period
- Investments are valued in accordance with relevant industry guidelines
- Investor drawdowns and distributions are authorised, processed and recorded completely and accurately
- Investment management fees, carried interest payments and expenses of the funds are authorised, accurately calculated, recorded and allocated in accordance with the fund's legal documentation
- Cash and investment positions are completely and accurately recorded and reconciled to third party data or documents of title held

Safeguarding assets

- Investments are properly registered and securely held
- Uninvested cash is managed with due regard to diversification of risk and security of funds

Monitoring compliance

- Investment performance is monitored
- Outsourced activities are properly managed and monitored and conflicts of interest identified to clients

Reporting to investors

- Investor reporting is complete and accurate and provided within required timescales
- Reports and accounts are prepared having regard to disclosure requirements and submitted in accordance with timescales determined by applicable law and regulations and are distributed to investors on a timely basis

Information technology

See Appendix 1 (g)

(ix) Investment administration – illustrative control objectives

Accepting clients

- Accounts are set up and administered in accordance with client agreements and applicable regulations
- Complete and authorised client agreements are operative prior to initiating administration activity
- Client take-ons ,including in specie transfers, are monitored, documented and opening positions are accurately reported to clients
- In-house pooled fund unit-holder activity is recorded completely, accurately and in a timely manner

Authorising and processing transactions

- Investment and related cash transactions are completely and accurately recorded and communicated for settlement in a timely manner
- Corporate actions are processed and recorded accurately and on a timely basis
- Client new monies and withdrawals are processed and recorded completely and accurately withdrawals are appropriately authorised

Maintaining financial and other records

- Investment income and related tax are accurately recorded in the proper period
- Investments are valued using current prices obtained from independent external pricing sources or determined according to approved pricing policies and procedures for fair values in circumstances where independent sources are not available
- Cash and investment positions are completely and accurately recorded and reconciled to third party data
- Expenses are accurately identified and recorded in accordance with client requirements and on a timely basis
- Pooled funds are priced and administered accurately and in a timely manner

Monitoring compliance

- Outsourced activities are properly managed and monitored and conflicts of interest identified to clients

Reporting to clients

- Periodic reports to clients and customers are accurate and complete and distributed on a timely basis

Information technology

See Appendix 1 (g)

Hedge fund management⁹ – illustrative control objectives¹⁰

Accepting clients

- New funds are properly structured and authorised (where applicable), take account of legal and tax requirements and contain a specified investment strategy
- Funds are set up and administered in accordance with the Fund's constitutional agreements and applicable regulations
- Prospective investors are assessed for suitability and complete relevant legal documentation prior to investment activity
- Investment limits and restrictions are established
- Responsibility for generating proxy voting instructions is clearly established

Authorising and processing transactions

- Investment strategy is set and implemented in a timely manner
- Investment transactions are properly authorised, executed and allocated in a timely and accurate manner
- Complete and authorised agreements with counterparties (eg, prime broker, administrator and custodian) are operative prior to initiating investment activity
- Transactions are undertaken only with approved counterparties
- Commission levels and transaction costs are monitored
- Corporate actions are processed and recorded accurately and in a timely manner
- Proxy voting instructions are generated and recorded and carried out accurately and in a timely manner
- Investor subscriptions and redemptions are processed and recorded completely and accurately; redemptions are appropriately authorised
- Where quantitative trading strategies are adopted, the design and review of such strategies models is monitored
- Trading activity is only undertaken within the parameters of the Fund's investment strategy (eg, limits on leverage, concentration risk, counterparty risk, type of investments)

Maintaining financial and other records

- Investment income and related tax are accurately recorded in the proper period
- Investments are valued using current prices obtained from independent external pricing sources or determined according to approved pricing policies and procedures for fair values in circumstances where independent sources are not available
- Where reliable market price data is not available hard-to-value assets are valued using consistent valuation arrangements which mitigate conflicts of interest and are disclosed to investors
- Cash and investment positions are completely and accurately recorded
- Reconciliations are undertaken between the prime broker, the administrator and the custodian for daily trades, investment positions, settlements and cash in a timely and accurate manner
- Lock-up periods, redemption gates and penalties are accurately applied in accordance with the Fund's constitutional agreements

⁹ Hedge fund managers may also consider relevant industry standards and codes of conduct. ¹⁰ Managers of funds of hedge funds may consider which of these control objectives are relevant and consider what additional control objectives are appropriate.

- Where hard-to-value assets are placed in side pockets, they are appropriately identified and recorded in accordance with the Fund's constitutional agreements
- Investment management and performance fees and other account expenses are authorised, accurately calculated and recorded

Safeguarding assets

- Liquidity management is undertaken with due regard to investor subscriptions and redemptions, margin calls, terms and duration of bank borrowing and the payments due to creditors
- Uninvested cash is managed with due regard to diversification of risk and security of funds
- Investments are properly registered and client money is segregated

Monitoring compliance

- Fund portfolios are managed in accordance with investment objectives, monitored for compliance with investment limits and restrictions and performance is measured
- Outsourced activities, including arrangements with prime brokers, administrators and transfer agents are properly managed and monitored and conflicts of interest identified to clients
- Transaction errors (including guidelines breaches) are rectified promptly and investors treated fairly
- Portfolio liquidity is monitored in accordance with client instruction in order to meet redemption requests in a timely manner
- Levels of leverage, margin calls, counterparty exposures and potential events of default are monitored

Reporting to investors

- Reporting to investors in respect of fund net asset values, portfolio transactions, investment holdings, performance, commission and voting and other information agreed with investors is complete and accurate and provided with required timescales

Information technology

See Appendix 1 (g)

2. Example paragraphs from the report by the directors

As directors we are responsible for the identification of control objectives relating to customers' assets⁴¹ and related transactions in the provision of [financial services¹²] and the design, implementation and operation of the control procedures of [name of entity] to provide reasonable assurance that the control objectives are achieved.

In carrying out those responsibilities we have regard not only to the interests of customers but also to those of the owners of the business and the general effectiveness and efficiency of the relevant operations.

We have evaluated the effectiveness of the [name of entity]'s control procedures having regard to ICAEW Technical Release AAF 01/06 and the criteria for [financial services] set out therein.

We set out in this report a description of the relevant control procedures together with the related control objectives which operated during the period [x] to [y] and confirm that

- i. the report describes fairly the control procedures that relate to the control objectives referred to above which were in place as at [date];
- ii. the control procedures described are suitably designed such that there is reasonable assurance that the specified control objectives would be achieved if the described control procedures were complied with satisfactorily [and customers applied the control procedures contemplated⁴²]; and
- iii. the control procedures described were operating with sufficient effectiveness to provide reasonable assurance that the related control objectives were achieved during the specified period.

Director

Date

Signed on behalf of the Board of Directors

⁴¹ The reference to 'assets' may need to be expanded here and elsewhere in the report: see footnote 3, page 5. ¹² Refer to relevant financial services as per paragraph 6, page 2.

⁴² This additional wording may be considered appropriate in circumstances described in paragraph 43, page 8.

3. Pro-forma reporting accountants' assurance reports (i) and (ii) (revised July 2016)

(a) Engagement formed between the reporting accountant and the service organisation and to which customers of the service organisation are party

Reporting accountants' assurance report on internal controls of service organisations⁴³

To the directors of [name of entity] and [customers party to the engagement]

Use of report⁴⁴

This report is made solely for the use of the directors, as a body, of [name of entity] and [customers party to the engagement], and solely for the purpose of reporting on the internal controls of [name of entity], in accordance with the terms of our engagement letter dated [date] [and attached⁴⁵ as appendix []].

Our work has been undertaken so that we might report to the directors and [customers party to the engagement] those matters that we have agreed to state to them in this report and for no other purpose. Our report must not be recited or referred to in whole or in part in any other document nor made available, copied or recited to any other party, in any circumstances, without our express prior written permission.

To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the directors as a body, [name of entity] and [customers party to the engagement] for our work, for this report or for the opinions we have formed.

Subject matter

This report covers solely the internal controls of [name of entity] as described in your report as at [date]. Internal controls are processes designed to provide reasonable assurance regarding the level of control over customers' assets⁴⁶ and related transactions achieved by [name of entity] in the provision of [outsourced activities] by [name of entity].

The directors' responsibilities and statement are set out on page []. Our responsibility is to form an independent conclusion, based on the work carried out in relation to the control procedures of [name of entity]'s [] function carried out at the specified business units of [name of entity] [located at []] **as described in the directors' report and** report this to the directors of [name of entity] and [customers party to the engagement].

Our independence and quality control

We have complied with the independence and other ethical requirements of the ICAEW Code of Ethics, which includes the requirements of the Code of Ethics for Professional Accountants issued by the International Ethics Standards Board for Accountants, which is founded on fundamental principles of integrity, objectivity, professional competence and due care, confidentiality and professional behaviour.

⁴³ Reporting accountants consider a suitable form of report in accordance with the specific engagement as described in paragraph 55. This report provides an example for an engagement to which customers of the service organisation are party (see paragraph 55(a)).

⁴⁴ The two last paragraphs in 'Use of report' provide example wording, disclaiming reporting accountants' liability or duty to the customers that are not party to the engagement. Reporting accountants consider the legal effectiveness of disclaiming liability in the particular circumstances of their engagement.

⁴⁵ Reporting accountants that do not attach the engagement letter consider including relevant extracts.

⁴⁶ The reference to 'assets' may need to be expanded here and elsewhere in the report: see footnote 3, page 5.

The firm applies International Standard on Quality Control 1 and accordingly maintains a comprehensive system of quality control including documented policies and procedures regarding compliance with ethical requirements, professional standards and applicable legal and regulatory requirements.

Criteria and scope

We conducted our engagement in accordance with International Standard on Assurance Engagements (ISAE) 3000 and ICAEW Technical Release AAF 01/06. The criteria against which the control procedures were evaluated are the internal control objectives developed for service organisations as set out within the Technical Release AAF 01/06 and identified by the directors as relevant control objectives relating to the level of control over customers' assets and related transactions in the provision of [outsourced activities]. Our work was based upon obtaining an understanding of the control procedures as described on page [] to [] in the report by the directors, and evaluating the directors' statement on page [] to [] in the same report to obtain reasonable assurance so as to form our conclusion.

Inherent limitations

Control procedures designed to address specified control objectives are subject to inherent limitations and, accordingly, errors or irregularities may occur and not be detected. Such control procedures cannot guarantee protection against (among other things) fraudulent collusion especially on the part of those holding positions of authority or trust. Furthermore, our conclusion is based on historical information and the projection of any information or conclusions in the attached report to any future periods would be inappropriate.

Conclusion

In our opinion, in all material respects:

- (i) the accompanying report by the directors describes fairly the control procedures that relate to the control objectives referred to above which were in place as at [date];
- (ii) the control procedures described on pages [] to [] were suitably designed such that there is reasonable, but not absolute, assurance that the specified control objectives would have been achieved if the described control procedures were complied with satisfactorily [and customers applied the control procedures contemplated⁴⁷]; and
- (iii) the control procedures that were tested, as set out in the attachment to this report, were operating with sufficient effectiveness for us to obtain reasonable, but not absolute, assurance that the related control objectives were achieved in the period [x] to [y].

⁴⁷ See footnote 13, page 37.

Name of firm Chartered Accountants Location Date

(b) Engagement formed between the reporting accountant and the service organisation only

Reporting accountants' assurance report on internal controls of service organisations⁴⁸

To the directors of [name of entity]

Use of report²⁰

This report is made solely for the use of the directors, as a body, of [name of entity], and solely for the purpose of reporting on the internal controls of [name of entity], in accordance with the terms of our engagement letter dated [date] [and attached⁴⁹ as appendix []].

Our work has been undertaken so that we might report to the directors those matters that we have agreed to state to them in this report and for no other purpose. Our report must not be recited or referred to in whole or in part in any other document nor made available, copied or recited to any other party, in any circumstances, without our express prior written permission.

We permit the disclosure of this report, in full only, by the directors at their discretion to customers [of [name of entity] using [name of entity]'s [financial services²²] ('customers'),] and to the auditors of such customers, to enable customers and their auditors to verify that a report by reporting accountants has been commissioned by the directors of [name of entity] and issued in connection with the internal controls of [name of entity], and without assuming or accepting any responsibility or liability to customers or their auditors on our part.

To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the directors as a body and [name of entity] for our work, for this report or for the conclusions we have formed⁵⁰.

⁴⁸ Reporting accountants consider a suitable form of report in accordance with the specific engagement as described in paragraph 55. This report provides an example for an engagement formed between the reporting accountants and the service organisation only, applicable to arrangements (c) and (d) as described in paragraph 55, page 10–11. The sentence beginning 'we permit' is adapted where paragraph 55(c) is applied. ²⁰ The three last paragraphs in 'Use of report' provide example wording, disclaiming reporting accountants' liability or duty to the customers that are not party to the engagement. Reporting accountants consider the legal effectiveness of disclaiming liability in the particular circumstances of their engagement.

⁴⁹ Reporting accountants that do not attach the engagement letter consider including relevant extracts.

²² See footnote 12, page 32.

⁵⁰ If arrangement (b) as described in paragraph 55 is considered appropriate then accountants consider including reference to the facility for customers meeting a firm's client acceptance criteria to enjoy a duty of care from the accountants if they accept the relevant terms of the engagement letter agreed previously with the service organisation. Wording that might be used (in particular in place of the paragraphs shown above and beginning 'We permit' and 'To the fullest extent' is as follows: 'Subject as follows, we are prepared to extend our assumption of responsibility to those customers who first accept in writing (in a form provided to us and confirmed by us to be acceptable to us) the relevant terms of the engagement letter agreed previously with [name of entity] as if the customer had signed that letter when originally issued, and including the provisions limiting liability contained in that letter. This extension will not apply to a customer where we inform that customer, whether before or after the customer accepts the relevant terms of the engagement letter, that they do not meet our client acceptance criteria.

To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the directors as a body, the organisation and any customer to whom the extension does apply, for our work, for this report or for the conclusions we have formed.'

Subject matter

This report covers solely the internal controls of [name of entity] as described in your report as at [date]. Internal controls are processes designed to provide reasonable assurance regarding the level of control over customers' assets⁵¹ and related transactions achieved by [name of entity] in the provision of [outsourced activities] by [name of entity].

The directors' responsibilities and statement are set out on page []. Our responsibility is to form an independent conclusion, based on the work carried out in relation to the control procedures of [name of entity]'s [] function carried out at the specified business units of [name of entity] [located at []] **as described in the directors' report and** report this to the directors of [name of entity] and [customers party to the engagement].

Our independence and quality control

We have complied with the independence and other ethical requirements of the ICAEW Code of Ethics, which includes the requirements of the Code of Ethics for Professional Accountants issued by the International Ethics Standards Board for Accountants, which is founded on fundamental principles of integrity, objectivity, professional competence and due care, confidentiality and professional behaviour.

The firm applies International Standard on Quality Control 1 and accordingly maintains a comprehensive system of quality control including documented policies and procedures regarding compliance with ethical requirements, professional standards and applicable legal and regulatory requirements.

Criteria and scope

We conducted our engagement in accordance with International Standard on Assurance Engagements (ISAE) 3000 (revised) and ICAEW Technical Release AAF 01/06. The criteria against which the control procedures were evaluated are the internal control objectives developed for service organisations as set out within the Technical Release AAF 01/06 and identified by the directors as relevant control objectives relating to the level of control over customers' assets and related transactions in the provision of [outsourced activities]. Our work was based upon obtaining an understanding of the control procedures as described on page [] to [] in the report by the directors, and evaluating the directors' statement on page [] to [] in the same report to obtain reasonable assurance so as to form our conclusion.

Inherent limitations

Control procedures designed to address specified control objectives are subject to inherent limitations and, accordingly, errors or irregularities may occur and not be detected. Such control procedures cannot guarantee protection against (among other things) fraudulent collusion especially on the part of those holding positions of authority or trust. Furthermore, our conclusion is based on historical information and the projection of any information or conclusions in the attached report to any future periods would be inappropriate.

Conclusion

In our opinion, in all material respects:

⁵¹ The reference to 'assets' may need to be expanded here and elsewhere in the report: see footnote 3, page 5.

- (i) the accompanying report by the directors describes fairly the control procedures that relate to the control objectives referred to above which were in place as at [date];
- (ii) the control procedures described on pages [] to [] were suitably designed such that there is reasonable, but not absolute, assurance that the specified control objectives would have been achieved if the described control procedures were complied with satisfactorily [and customers applied the control procedures contemplated⁵²]; and
- (iii) the control procedures that were tested, as set out in the attachment to this report, were operating with sufficient effectiveness for us to obtain reasonable, but not absolute, assurance that the related control objectives were achieved in the period [x] to [y].

Name of firm Chartered Accountants Location Date

⁵² See footnote 13, page 37.

4. Examples of explanatory paragraphs and qualification wording

(a) Description misstatements

Appendix 1 specifies a minimum set of control objectives for inclusion in the directors' reports. Exceptionally, in the event that the directors decide not to include a particular control objective in their report then their report explains the fact and the reasons for the omission. Where directors fail or refuse to disclose the omission, or the reporting accountants consider the justification being unsatisfactory, the reporting accountants disclose the fact and qualify their opinion. For example:

We draw attention to page [x] of the report by the directors which sets out the control objectives. One of the control objectives, [specify], in Technical Release AAF 01/06, is not included in the directors' report and no reason for the omission is explained.

Except for the matter referred to above concerning the fairness of the description of control procedures, in our opinion, ...

The refusal or failure of the directors to amend incomplete or inappropriate descriptions of control procedures or control objectives, may lead to the description of internal controls being considered not fair. Where the reporting accountants consider that this merits qualification, this might be phrased as follows:

The report by the directors states, on page [x], that cash records are reconciled to bank statements on a daily basis. Our work indicates that whilst this is the procedure for UK bank accounts, reconciliations of overseas accounts are only carried out as and when bank statements are received, which is typically once per month.

Except for the matter referred to above concerning the fairness of the description of control procedures, in our opinion, ...

(b) Design deficiencies

Design deficiencies may, for example, result either from a key control being absent or from control procedures that do not prevent or detect errors as described. The following is an example of wording that may be appropriate where reporting accountants qualify their opinion on the control design due to the absence of a key control.

As explained on page [x] of the report by the directors six monthly reconciliations of physical securities held to the books and records are undertaken. The reconciliation procedures did not however include a control for follow up of reconciling items and for independent review and approval of the reconciliations.

Except for the matter referred to above concerning the control design, in our opinion, ...

(c) Exceptions to operating effectiveness

Tests of operating effectiveness carried out by reporting accountants in relation to specific control procedures are detailed either (a) adjacent to the relevant control procedures in the report by the directors or (b) in an appendix to the assurance report. Where the results of the tests identify an exception to the control procedures, this is reported after the test, and the reporting accountants consider whether the exceptions affect the achievement of the control objective. Where the achievement of the control objective deserves qualification the reporting accountants insert an explanatory paragraph with appropriate reference and modify their opinion.

On page [x] of the report by the directors it is stated that six monthly reconciliations of physical securities held to the books and records are undertaken and that there is a process for following

up reconciling items. Our tests of operating effectiveness indicated that there were a significant number of reconciling items that were not being resolved on a timely basis in accordance with the organisation's policy.

Except for the matter referred to above concerning the operating effectiveness of the control procedures, in our opinion, ...

Where the results of the reporting accountants' tests of operational effectiveness and the deficiency have been integrated and fully explained into the report by the directors the reporting accountants may alternatively consider cross-referring their qualification to where these details may be found. For example:

Except for the matter explained on page [z] concerning the follow up of reconciling items on physical security reconciliations, the control procedures tested, as set out [on pages [x] to [y] of the report by the directors/ in the attachment to this report], in our opinion.

5. Example extracts from an engagement letter

These extracts are provided for illustrative purposes only. Reporting accountants apply their own judgement to develop suitable wording for their engagement letters to reflect the guidance in this Technical Release and their own particular circumstances⁵³.

Responsibilities of directors

The board of directors ('the Directors') of [name of entity] in relation to which the reporting accountants' assurance report is to be provided ('the Organisation') are and shall be responsible for the design, implementation and operation of control procedures that provide adequate level of control over customers' assets⁵⁴ and related transactions. The Directors' responsibilities are and shall include:

- acceptance of responsibility for internal controls;
- evaluation of the effectiveness of the service organisation's control procedures using suitable criteria;
- supporting their evaluation with sufficient evidence, including documentation; and
- providing a written report ('Directors' Report') of the effectiveness of the service organisation's internal controls for the relevant financial period.

In drafting this report the Directors have regard to, as a minimum, the criteria specified within the Technical Release AAF 01/06 issued by ICAEW but they may add to these to the extent that this is considered appropriate in order to meet customers' expectations.

Responsibilities of reporting accountants

It is our responsibility to form an independent conclusion, based on the work carried out in relation to the control procedures of the Organisation's [] function carried out at the specified business units of the Organisation [located at []] as described in the Directors' report and report this to the Directors.

Scope of the reporting accountants' work

We conduct our work in accordance with the procedures set out in AAF 01/06, issued by the Institute. Our work will include enquiries of management, together with tests of certain specific control procedures which will be set out in an appendix to our report.

In reaching our conclusion, the criteria against which the control procedures are to be evaluated are the internal control objectives developed for service organisations as set out within the AAF 01/06 issued by ICAEW.

⁵³ The above extracts may be appropriate illustrations only for an engagement formed between the reporting accountants and the service organisation. Where a multi-party engagement is formed in line with paragraph 55(a), wording should be revised and additional clauses should be inserted as appropriate. Where a customer agrees to sign up to the engagement terms at a later date, additional wording maybe inserted in line with paragraph 55(b) to clarify the basis on which the customer signs up and to secure the consent of the service organisation/original addressees. The wording will include adjustment of the section on 'Use of Report' and the addition of wording in the section

on Liability Provisions to refer to the provisions applying to 'the Directors as a body, the Organisation (and customers who are or become, by signature, a party to the engagement letter)' and to losses suffered by, and aggregate liability to, 'the Directors as a body, the Organisation (and any customers who are or become, by signature, a party to the engagement letter)'.

⁵⁴ The reference to 'assets' may need to be expanded here and elsewhere in the report: see footnote 3, page 5.

Any work already performed in connection with this engagement before the date of this letter will also be governed by the terms and conditions of this letter.

We may seek written representations from the Directors in relation to matters on which independent corroboration is not available. We shall seek confirmation from the Directors that any significant matters of which we should be aware have been brought to our attention.

Inherent limitations

The Directors acknowledge that control procedures designed to address specified control objectives are subject to inherent limitations and, accordingly, errors or irregularities may occur and not be detected. Such procedures cannot guarantee protection against fraudulent collusion especially on the part of those holding positions of authority or trust. Furthermore, the opinion set out in our report will be based on historical information and the projection of any information or conclusions in our report to any future periods will be inappropriate.

Use of our report

Our report will, subject to the permitted disclosures set out in this letter, be made solely for the use of the Directors of the Organisation, and solely for the purpose of reporting on the internal controls of the Organisation, in accordance with these terms of our engagement.

Our work will be undertaken so that we might report to the Directors those matters that we have agreed to state to them in our report and for no other purpose.

Our report will be issued on the basis that it must not be recited or referred to or disclosed, in whole or in part, in any other document or to any other party, without the express prior written permission of the reporting accountants. We permit the disclosure of our report, in full only, to customers [of the Organisation using the Organisation's [financial services⁵⁵] ('customers')] [(as defined in appendix [] to this letter),] and to the auditors of such customers, to enable customers and their auditors to verify that a report by reporting accountants has been commissioned by the Directors of the Organisation and issued in connection with the internal controls of the Organisation without assuming or accepting any responsibility or liability to them on our part.

To the fullest extent permitted by law, we do not and will not accept or assume responsibility to anyone other than the Directors as a body and the Organisation for our work, for our report or for the opinions we will have formed⁵⁶.

Liability provisions⁵⁷

We will perform the engagement with reasonable skill and care and acknowledge that we will be liable to the Directors as a body and the Organisation for losses, damages, costs or expenses ('losses') suffered by the Directors as a body and the Organisation as a result of our breach of contract, negligence, fraud or other deliberate breach of duty. Our liability shall be subject to the following provisions:

- We will not be so liable if such losses are due to the provision of false, misleading or incomplete information or documentation or due to the acts or omissions of any person other than us, except

⁵⁵ See footnote 12, page 32.

⁵⁶ See footnote 23, page 35.

⁵⁷ Reporting accountants may wish to seek independent legal advice on language that addresses both the matters covered in the illustrative wording set out in this Liability section together with any related matters such as provisions indicating that liability does not extend to consequential losses. Accountants may also consider any applicable independence requirements.

where, on the basis of the enquiries normally undertaken by us within the scope set out in these terms of engagement, it would have been reasonable for us to discover such defects;

- We accept liability without limit for the consequences of our own fraud or other deliberate breach of duty and for any other liability which it is not permitted by law to limit or exclude;
- Subject to the previous provisions of this Liability paragraph, our total aggregate liability whether in contract, tort (including negligence) or otherwise, to the Directors as a body and the Organisation, arising from or in connection with the work which is the subject of these terms (including any addition or variation to the work), shall not exceed the amount of [To be discussed and negotiated];

To the fullest extent permitted by law, the Organisation agrees to indemnify and hold harmless [name of reporting accountants] and its partners and staff against all actions, proceedings and claims brought or threatened against [name of reporting accountants] or against any of its partners and staff by any persons other than the Directors as a body and the Organisation, and all loss, damage and expense (including legal expenses) relating thereto, where any such action, proceeding or claim in any way relates to or concerns or is connected with any of [name of reporting accountants]'s work under this engagement letter.

The Directors as a body and the Organisation agree that they will not bring any claims or proceedings against any of our individual partners, members, directors or employees. This clause is intended to benefit such partners, members, directors and employees who may enforce this clause pursuant to the Contracts (Rights of Third Parties) Act 1999 ('the Act'). Notwithstanding any benefits or rights conferred by this agreement on such partners, members, directors or employees by virtue of the Act, we and the Directors as a body may together agree in writing to vary or rescind the agreement set out in this letter without the consent of any such partners, members, directors or employees. Other than as expressly provided in this paragraph, the provisions of the Act are excluded;

Any claims, whether in contract, negligence or otherwise, must be formally commenced within [years] after the party bringing the claim becomes aware (or ought reasonably to have become aware) of the facts which give rise to the action and in any event no later than [years] after any alleged breach of contract, negligence or other cause of action. This expressly overrides any statutory provision which would otherwise apply.

This engagement is separate from, and unrelated to, our audit work on the financial statements of the Organisation for the purposes of the Companies Act 1985 (or its successor) or other legislation and nothing herein creates obligations or liabilities regarding our statutory audit work, which would not otherwise exist. [Equivalent paragraphs where the Organisation is other than a Companies Act entity].

[Appendix : The list of customers to whom the assurance report may be made available⁵⁸.]

⁵⁸ A list of customers may not be practical where they are multiple.

6. Example sample size table

In determining the number of items to be tested the reporting accountants need to consider the factors referred to in paragraph 81. Although the extent of testing is a matter of judgement on the part of the reporting accountants the table set out below illustrates a range of possible sample sizes which may assist in making such judgements.

Frequency of control	Number of items tested
Annual	1
Quarterly	1, 2, 3
Monthly	2, 3, 4, 5
Weekly	5, 10, 15
Daily	15, 20, 30, 40
Multiple times per day	25, 30, 45, 60

7. Illustrative definition of enquiry, inspection, observation and re-performance

In describing the nature of tests carried out, it is desirable for the reporting accountants to define in their report what is meant by such procedures as enquiry, inspection, observation and re-performance (see paragraph 84). Illustrative definitions which may assist reporting accountants in this regard are set out below.

Enquiry

Enquired of appropriate [name of entity] personnel. Enquiries seeking relevant information or representation from personnel were performed to obtain, among other things:

- knowledge, additional information and affirmation regarding the control of procedures; and
- corroborating evidence of the control procedures.

Inspection

Inspected documents and records indicating performance of the control procedures. This included, among other things:

- inspection of reconciliations and management reports that age and/or quantify reconciling items to assess whether balances and reconciling items appear to be properly monitored, controlled and resolved on a timely basis, as required by the related control;
- examination of source documentation and authorisations related to selected transactions processed;
- examination of documents or records for evidence of performance such as the existence of initials or signatures; and
- inspection of [name of entity]'s systems documentation, such as operations, manuals, flow charts and job descriptions.

Observation

Observed the application or existence of specific control procedures as represented.

Re-performance

Re-performed the control or processing application of the control procedures to check the accuracy of their operation. This included, among other things:

- obtaining evidence of the arithmetical accuracy and correct processing of transactions by performing independent calculations; and
- re-performing the matching of various system records by independently matching the same records and comparing reconciling items to reconciliations prepared by the service organisation.

8. International Standard on Assurance Engagements (ISAE) 3402 Assurance Reports on Controls at a Service Organisation and a pro-forma report, revised for assurance reports dated on or after 15 December 2015

In December 2009, the International Auditing and Assurance Standards Board (IAASB) issued International Standard on Assurance Engagements (ISAE) 3402 *Assurance Reports on Controls at a Service Organization*. Consequential amendments were made to this standard by the IAASB at the same time as they issued ISAE 3000 (revised) which take effect for assurance reports signed on or after 15 December 2015. This ISAE is to be applied in a reasonable assurance engagement to report on financial reporting controls at a service organisation. It addresses reports on the description, design and operating effectiveness of controls relating to the broad range of services provided by service organisations. The standard applies internationally.

This appendix is issued to assist with the implementation of ISAE 3402 as the principal reporting framework for reports on internal controls at service organisations in the United Kingdom. ISAE 3402 is consistent with the existing ICAEW guidance AAF 01/06 which provides sets of control objectives as criteria against which internal controls may be assessed.

This Appendix provides a pro-forma report for reporting using ISAE 3402, ISAE 3000 (revised) and AAF 01/06.

There are two key differences between ISAE 3402 and AAF 01/06 which are relevant to considering the scope of the work of reporting accountants. Firstly ISAE 3402's scope is narrower than AAF 01/06 in that it deals only with assurance engagements to report on internal controls at a service organisation that are likely to be relevant to user organisations' internal controls as they relate to financial reporting. Practitioners performing assurance reporting on internal controls that do not relate to financial reporting follow ISAE 3000 (revised) and AAF 01/06⁵⁹. Secondly, in the context of a report that covers controls in operation for a given period ('a type 2 report'), ISAE 3402 requires reporting accountants to report on the fairness of the description and on the design of control procedures throughout the period rather than as of the date at the end of the period.

The structure of reporting under ISAE 3402 has the same key characteristics of an assurance engagement under AAF 01/06 as both are based on ISAE 3000 (revised). These are:

- A three-party relationship
- Appropriate subject matter
- Suitable criteria
- Sufficient appropriate evidence, and
- A written assurance report

ISAE 3402 sets out details of how practitioners should undertake their assurance engagements. AAF 01/06 continues to provide guidance on the responsibilities of a service organisation, guidance for reporting accountants on managing professional liability, and details of the illustrative control objectives agreed with relevant industry bodies or regulators that are considered suitable criteria and collectively reflect the level of service organisations' control over customers' assets and related transactions. Reporting accountants issuing an ISAE 3402 report need to read and comply with ISAE 3402 as reading AAF 01/06 including this appendix alone does not substitute for reading the international standard.

⁵⁹ For some service organisations there may be controls that are closely related to those for financial reporting. Whether such controls, which are typically in operations or compliance, are likely to be relevant to internal control as it relates to financial reporting will be a matter of professional judgement.

A pro-forma reporting accountants' assurance report in accordance with ISAE 3402²⁹

Reporting accountants issue an assurance report in a form suitable for the specific engagement. The report below is based on one of the pro-forma reporting accountants' assurance reports (ii) Engagement formed between the reporting accountant and the service organisation only in Appendix 3 of AAF 01/06 and provides an illustrative type 2 report.

Reporting accountants' assurance report on internal controls of service organisation³⁰

To the directors of [name of entity]

Use of report³¹

This report is made solely for the use of the directors, as a body, of [name of entity], and solely for the purpose of reporting on the internal controls of [name of entity], in accordance with the terms of our engagement letter dated [date] [and attached³² as appendix []].

Our work has been undertaken so that we might report to the directors those matters that we have agreed to state to them in this report and for no other purpose. Our report must not be recited or referred to in whole or in part in any other document nor made available, copied or recited to any other party, in any circumstances, without our express prior written permission.

We permit the disclosure of this report, in full only, by the directors at their discretion to customers [of [name of entity] using [name of entity]'s [financial services³³] ('customers'),] and to the auditors of such customers, to enable customers and their auditors to verify that a report by reporting accountants has been commissioned by the directors of [name of entity] and issued in connection with the internal controls of [name of entity], and without assuming or accepting any responsibility or liability to customers or their auditors on our part.

To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the directors as a body and [name of entity] for our work, for this report or for the conclusions we have formed.³⁴

²⁹ ISAE 3402 uses the term 'service auditor', which may be substituted for 'reporting accountant' throughout this report if preferred.

³⁰ Reporting accountants consider a suitable form of report in accordance with the specific engagement as described in paragraph 55 of AAF 01/06. This report provides an example for an engagement formed between the reporting accountants and the service organisation only, applicable to arrangements (c) and (d) as described in paragraph 55.

³¹ The three last paragraphs in 'Use of Report' provide example wording, disclaiming reporting accountants' liability or duty to the customers that are not party to the engagement. Reporting accountants consider the legal effectiveness of disclaiming liability in the particular circumstances of their engagement.

³² Reporting accountants that do not attach the engagement letter consider including relevant extracts.

³³ See footnote 12, page 32.

³⁴ If arrangement (b) as described in paragraph 55 is considered appropriate then reporting accountants consider including reference to the facility for customers meeting a firm's client acceptance criteria to enjoy a duty of care from the reporting accountants if they accept the relevant terms of the engagement letter agreed previously with the service organisation. Wording that might be used (in particular in place of the paragraphs shown above and beginning 'We permit' and 'To the fullest extent' is as follows: 'Subject as follows, we are prepared to extend our assumption of responsibility to those customers who first accept in writing (in a form provided to us and confirmed by us to be acceptable to us) the relevant terms of the engagement letter agreed previously with [name of entity] as if the customer had signed that letter when originally issued, and including the provisions limiting liability contained in that letter. This extension will not apply to a customer where we inform that customer, whether before or after the customer accepts the relevant terms of the engagement letter, that they do not meet our client acceptance criteria. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the directors as a body, the organisation and any customer to whom the extension does apply, for our work, for this report or for the conclusions we have formed.'

Scope

We have been engaged to report on [name of entity]'s description of its [service organisation activities or system] throughout the period [date] to [date] (the description), and on the suitability of the design and operating effectiveness of controls to achieve the related control objectives stated in the description.

Service organisation's responsibilities

[Name of entity] is responsible for: preparing the description and the accompanying statement set out on page [], including the completeness, accuracy, and method of presentation of the description and the statement; providing the services covered by the description; specifying the criteria including the control objectives and stating them in the description; identifying the risks that threaten the achievement of the control objectives; and designing, implementing and effectively operating controls to achieve the related control objectives stated in the description.

The control objectives stated in the description include the internal control objectives developed for service organisations as set out in the ICAEW Technical Release AAF 01/06.

Our independence and quality control

We have complied with the independence and other ethical requirements of the ICAEW Code of Ethics, which includes the requirements of the Code of Ethics for Professional Accountants issued by the International Ethics Standards Board for Accountants, which is founded on fundamental principles of integrity, objectivity, professional competence and due care, confidentiality and professional behaviour.

The firm applies International Standard on Quality Control 1 and accordingly maintains a comprehensive system of quality control including documented policies and procedures regarding compliance with ethical requirements, professional standards and applicable legal and regulatory requirements.

Reporting accountants' responsibilities

Our responsibility is to express an opinion on the fairness of the presentation of the description and on the suitability of the design and operating effectiveness of the controls to achieve the related control objectives stated in that description. We conducted our engagement in accordance with International Standard on Assurance Engagements 3402, and ICAEW Technical Release AAF 01/06. That standard and guidance require that we plan and perform our procedures to obtain reasonable assurance about whether, in all material respects, the description is fairly presented and the controls were suitably designed and operating effectively to achieve the related control objectives stated in the description, throughout the period [date] to [date].

Our work involved performing procedures to obtain evidence about the presentation of the description of the [service organisation activities or system] and the design and operating effectiveness of those controls. Our procedures included assessing the risks that the description is not fairly presented and that the controls were not suitably designed or operating effectively to achieve the related control objectives stated in the description. Our procedures also included testing the operating effectiveness of those controls that we consider necessary to provide reasonable assurance that the related control objectives stated in the description were achieved. An assurance engagement of this type also includes evaluating the overall presentation of the description and the suitability of the control objectives stated therein, and the suitability of the criteria specified by the service organisation and described at page [].

Inherent limitations

[Name of entity's] description is prepared to meet the common needs of a broad range of customers and their auditors and may not, therefore, include every aspect of the [service organisation activities or system] that each individual customer may consider important in its own particular environment. Also, because of their nature, controls at a service organisation may not prevent or detect and correct all errors or omissions in processing or reporting transactions [or identification of the function performed by the service organisation or system].

Our opinion is based on historical information and the projection to future periods of any evaluation of the fairness of the presentation of the description, or opinions about the suitability of the design or operating effectiveness of the controls would be inappropriate.

Opinion

In our opinion, in all material respects, based on the criteria including specified control objectives described in the directors' statement on page []:

- (a) the description on pages [] to [] fairly presents the [service organisation activities or system] that were designed and implemented throughout the period from [date] to [date];
- (b) the controls related to the control objectives stated in the description on pages [] to [] were suitably designed to provide reasonable assurance that the specified control objectives would be achieved if the described controls operated effectively throughout the period from [date] to [date];
- (c) the controls that we tested were operating with sufficient effectiveness to provide reasonable assurance that the related control objectives stated in the description were achieved throughout the period [date] to [date].

Description of tests of controls

The specific controls tested and the nature, timing and results of those tests are detailed on Pages [] to [].

Reporting Accountants

Location

Date

Assurance reporting on the UK Stewardship Code

(Revised AAF 01/06 Stewardship Supplement³⁵)

The Financial Reporting Council (FRC) consulted in April 2012 on changes to the UK Stewardship Code and issued a revised version (the Code) in September 2012 (effective from 1 October 2012)³⁶. As noted in the Code, the latest edition does not change the spirit of the 2010 Code.

The FRC encourages all signatories to review their policy statements with a view to producing an updated statement as soon as practical. Where an organisation has updated its policy statement to accord with the Code, this revised AAF 01/06 Stewardship Supplement should be applied.

Background

The Code intends to enhance the quality of engagement between institutional investors and the companies they invest in to help improve long-term returns to investors and the efficient exercise of governance responsibilities.

The FRC sees the Code as complementary to the UK Corporate Governance Code for listed companies, as it should create a link between governance of companies and the investment process. Public disclosures made by asset managers under the Code are intended to assist companies to understand the approach and expectations of their major investors.³⁷ They should also assist those issuing mandates to asset managers to make a more informed choice, thereby improving the functioning of the market and facilitating the exercise of responsibility on behalf of clients or beneficiaries.

The Code is directed in the first instance to institutional investors, by which is meant asset owners and asset managers with equity holdings in UK listed companies. The Code also applies, by extension, to service providers, such as proxy advisors and investment consultants to which institutional investors may choose to outsource some of the activities associated with stewardship. However, the Code reminds these institutional investors that their responsibilities for stewardship cannot be delegated. The FRC expects that a statement describing how the Code has been applied should be easily found on the signatories' website or in another accessible form.

The application of the Code is on a 'comply or explain' basis. In reporting terms, this entails signatories providing a statement (Policy Statement) that contains:

- a description of how each of the Principles of the Code have been applied and disclosure of the specific information requested in the guidance to the Principles; or
- if one or more of the Principles have not been applied or the specific information requested in the guidance has not been disclosed, an explanation of why the signatory has not complied with those elements of the Code. The statement of how the Code has been applied should be aligned with the signatory's role in the investment chain.

Independent assurance reporting

Principle 7 of the Code states that institutional investors should report periodically on their stewardship and voting activities. Related guidance contains the following:

³⁵ This Supplement is subject to revision to incorporate good practice that is expected to evolve over time.

³⁶ frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Stewardship-Code-September-2012.aspx

³⁷ See the Stewardship Code, Application of the Code, paragraphs 6-9, pp.2-3.

‘Asset managers that sign up to this Code should obtain an independent opinion on their engagement and voting processes having regard to an international standard or a UK framework such as AAF 01/06³⁸. The existence of such assurance reporting should be publicly disclosed. If requested, clients should be provided access to such assurance reports.’

Assurance reporting on the UK Stewardship Code

The Stewardship Supplement (the Supplement) to AAF 01/06 *Assurance reports on internal controls of service organisations made available to third parties*³⁹ as set out in pages 56-64 has been written to assist asset managers to obtain an independent assurance report. It is based on the following features:

- User-driven independent assurance reporting over a wide range of investment management related activities.
- Use of the framework set out in International Standard on Assurance Engagements (ISAE) 3000⁴⁰ which assists global understanding of the nature and extent of the assurance opinion given.
- Reporting accountants’ procedures to obtain reasonable assurance on the fairness of the description of how certain Principles have been applied.
- The objective of facilitating asset managers’ adoption of the Code and obtaining an assurance report on fairness of description in the first instance and widening the scope of reporting to cover design suitability and process implementation as good practices develop.
- The incorporation of criteria closely based on the Code against which the specified Principles are applied and the disclosure of the specific information listed under these Principles is evaluated for use by the responsible persons within the asset managers and the reporting accountants.
- The involvement of a panel of stakeholders, including users, preparers, reporting accountants and other interested parties (Stakeholder Panel).

As explained in the FRC implementation document⁴¹, this guidance on assurance reporting is focused on those aspects of the Code that are considered ‘objectively verifiable’ at present. The Supplement focuses on the provision of an assurance report covering, as a minimum, those elements of the Policy Statement that deal with the description of how Principles 1, 2, 4 (from October 2012), 6 and 7 of the Code have been applied and the disclosure of the specific information listed in the Code under those principles.

The guidance contained in AAF 01/06 provides a framework within which service organisations, such as asset managers, could provide information on their internal controls that they have applied to the provision of outsourced services such as investment management, and reporting accountants could provide independent assurance reports on those controls⁴⁵.

- a) AAF 01/06 typically envisages a report which provides an assurance opinion on: The description of the objectives (policies) and processes;
- b) The design effectiveness of the processes to meet the objectives (policies); and
- c) The operating effectiveness of the processes.

³⁸ Assurance reports on internal controls of service organisations made available to third parties.

³⁹ AAF 01/06 is available from icaew.com/en/technical/audit-and-assurance/assurance/technical-release-aaf01-06.

⁴⁰ ISAE 3000 Assurance Engagements Other Than Audits or Reviews of Historical Financial Information.

⁴¹ Implementation of the UK Stewardship Code, Financial Reporting Council, July 2010. See:

frc.org.uk/FRCDocuments/FRC/Implementation-of-the-UK-Stewardship-Code.aspx ⁴⁵ For a framework on providing independent assurance reports on aspects of business relationships other than internal controls, see AAF 02/07 *A framework for assurance reports on third party operations*. See icaew.com/index.cfm/route/154008.

The Supplement contemplates that assurance reporting on stewardship and voting would as a minimum address the description of the policies and processes but does not extend to design suitability or the effectiveness of the implementation of those policies and processes. The scope of assurance reporting relates to Principles 1, 2, 6, 7 and, from October 2012, Principle 4 of the Code and disclosure of the specific information set out in the guidance and whether it has been fairly described. Principles 3 and 5 of the Code are only covered insofar as they include disclosures for the policy statement; in other respects they are currently not considered objectively 'verifiable'. However, ICAEW intends to monitor how practice develops in this area and convene the AAF 01/06 Working Group and Stakeholder Panel to consider changes.

Although not specified in the Code, it is envisaged that any assurance reporting would be on an annual basis. Where asset managers choose to combine this with their existing assurance report based on AAF 01/06 or other relevant international standard on internal controls then the assurance opinion on the Code should be in a separate report within the same document because of the different nature of the assurance opinion.

Appendix 1 sets out Principles 1, 2, 4, 6 and 7 and a summary of related guidance in the Code. How stewardship is applied in practice by asset managers and asset owners may vary depending on their circumstances.

Key aspects of the guidance included in the Supplement

Against this background, the guidance in the Supplement highlights the following matters:

- The scope of the Code covered by the reporting accountants' assurance report: ISAE 3000 requires that the criteria need to be relevant, complete, reliable, neutral and understandable. On that basis, the Stakeholder Panel considered that currently Principles 1, 2, 4, 6 and 7 are relevant to assurance reporting. This is not to imply that the adoption of Principles 1, 2, 4, 6 and 7 should take precedence over the remaining Principles. As stated above, ICAEW, as represented by the Working Group and overseen by the Stakeholder Panel, will monitor evolving practice in relation to remaining Principles and consider including them within the scope of assurance reporting in the future.
- The scope of the reporting accountants' opinion: To encourage wider adoption of independent assurance reporting, the assurance opinion in this Supplement is based on the assumption that reporting accountants give an opinion on the fairness of the description of how the Principles have been applied and the disclosure of the specific information listed under the Principles. This should help minimise any incremental cost of the assurance engagement. As above, asset managers and reporting accountants may consider that the assurance report can, and possibly should on a pilot basis, go further than this and wish to cover the design suitability and the effectiveness of the process implementation. Relevant sections of AAF 01/06 may provide guidance for reporting on design suitability and the effectiveness of the policy and process implementation.
- Reporting accountants provide a reasonable assurance opinion based on the work they perform. Further guidance on their work procedures is included in the Supplement under 'Guidance for reporting accountants.'

The reporting accountants may provide details of work performed as part of their report. It is envisaged that in addition to the reporting accountants' report, the asset manager provides detailed disclosures within the document.

AAF 01/06 STEWARDSHIP SUPPLEMENT

Assurance reporting on the UK Stewardship Code

This Stewardship Supplement (the Supplement) provides guidance on assurance reporting on Principles 1, 2, 4, 6 and 7 of the UK Stewardship Code (the Code) for institutional investors issued by the FRC. The guidance supplements ICAEW Technical Release AAF 01/06 *Assurance reports on internal controls of service organisations made available to third parties*. AAF 01/06 is not affected by the issuance of this Supplement. The development of the guidance is based on discussions between a Stakeholder Panel and the Audit and Assurance Faculty of ICAEW. It is intended that the Panel and the Faculty will keep this Supplement under review to ensure that its content continues to be relevant and appropriate.

The Supplement consists of:

- Guidance for asset managers in relation to their Policy Statement on the application of the Principles and specific disclosures;
- Guidance for reporting accountants;
- Appendix 1: Principles and related guidance of the UK Stewardship Code; and
- Appendix 2: A pro forma reporting accountants' assurance report on the UK Stewardship Code.

Although not specified in the Code, it is envisaged that any assurance reporting would be done on an annual basis. Where asset managers choose to combine this with their existing assurance report based on AAF 01/06 or a relevant international standard on internal controls then the assurance opinion on the Code would be in a separate report within the same document because of the different nature of the assurance opinion being given.

Guidance for asset managers in relation to their Policy Statement on the application of the Principles and specific disclosures

In accordance with the preface to the Code, the Policy Statement should describe how the Principles of the Code have been applied and if one or more of the Principles have not been applied or the specific information requested in the guidance has not been disclosed, an explanation of why the signatory has not complied with those elements of the Code should be provided. The Principles state that investors should:

- publicly disclose their policy on how they will discharge their stewardship responsibilities (Principle 1);
- have a robust policy on managing conflicts of interest in relation to stewardship which should be publicly disclosed (Principle 2);
- monitor their investee companies (Principle 3);
- establish clear guidelines on when and how they will escalate their stewardship activities (Principle 4);
- be willing to act collectively with other investors where appropriate (Principle 5); have a clear policy on voting and disclosure of voting activity (Principle 6); and
- report periodically on their stewardship and voting activities (Principle 7).

The guidance to these Principles specifies certain information that should be covered in the Policy Statement, including:

- how the institutional investor applies stewardship with the aim of enhancing and protecting the value for the ultimate beneficiary or client (Principle 1);
- the institutional investor's activities within the investment chain, as well as the responsibilities that arise from those activities (Principle 1);
- how outsourcing of activities are compatible with the proper exercise of the institutional investor's stewardship responsibilities and what steps the institutional investor has taken to ensure that they are carried out in a manner consistent with the approach to stewardship set out in the statement (Principle 1);
- arrangements for integrating stewardship with the wider investment process (Principle 1);
- the policy for identifying and managing conflicts of interest with the aim of taking all reasonable steps to put the interests of the institutional investor's client or beneficiary first, including how matters are handled when the interests of clients or beneficiaries diverge from each other (Principle 2);
- the willingness to become an insider and the mechanism by which this could be done if the institutional investor may be willing to do so (Principle 3);
- circumstances when the institutional investor will actively intervene and regularly assess the outcomes of doing so (Principle 4);
- the policy on collective engagement, indicating the institutional investor's readiness to work with other investors through formal and informal groups when this is necessary to achieve their objectives and ensure companies are aware of concerns (Principle 5);
- the kinds of circumstances in which the institutional investor would consider participating in collective engagement (Principle 5);
-
- the institutional investor's approach to stock lending and recalling lent stock (Principle 6); how asset managers are reporting to their clients or beneficiaries (Principle 7);

- the existence of an assurance report on the institutional investor's engagement and voting processes having regard to an international standard or a UK framework such as AAF 01/06 (Principle 7).

Asset managers should have a Policy Statement describing how the Principles of the Code have been applied, disclosing the specific information listed under Principles 1, 2, 4, 6 and 7, and providing an explanation if any of these elements are not complied with. In preparing the Policy Statement, asset managers may wish to refer to Appendix 1 and also have a regard to paragraphs 37 to 41 of the core technical release AAF 01/06.

This Supplement provides guidance to reporting accountants when providing assurance reports on the specific matters that, in accordance with the guidance to the Principles in the Code, should be addressed in a Policy Statement or otherwise disclosed. Assurance reports do not cover the design suitability, the effectiveness of the process implementation or the outcomes of such policies. The AAF 01/06 Working Group and the Stakeholder Panel, established by the ICAEW Audit and Assurance Faculty will monitor evolving practice and consider whether to extend the scope.

Other information provided by asset managers

Where asset managers include information in their report on the application of Principles other than those Principles that are set out in Appendix 1, they should make it clear that this information is not covered within the scope of assurance reporting unless there is a specific agreement with the reporting accountants in the engagement letter that it should be included.

Guidance for reporting accountants

Reporting accountants' procedures on the fairness of the description

To assess the fairness of the asset manager's description of how the specified Principles are applied and the disclosure of the specific information listed under the Principles, reporting accountants perform the following procedures:

- a) Obtain an understanding of the specific policies and processes put in place to give effect to the specified Principles

Reporting accountants' work needed to gain this understanding includes:

- reviewing standard terms of contracts with customers to gain an understanding of the contractual stewardship obligations;
- making enquiries of, and discussing with the asset manager the processes in place to implement their stewardship policies;
- reviewing policies and process manuals and board or committee minutes;
- performing walk-throughs of certain of the processes;
- comparing their understanding of the stewardship obligations with the asset manager's description; and
- documenting the understanding gained.

- b) Substantiate the descriptions by corroborating them with evidence Reporting accountants' corroborative work involves:

- observing, obtaining and inspecting records of processes in place;
- examining other evidence and performing other procedures that are considered appropriate;
- obtaining written representations from management that the information provided is accurate and complete; and
- documenting the work performed.

By performing these procedures, reporting accountants consider whether the asset manager's description includes a complete set of policies and related processes applied to meet the specified Principles and related guidance set out in Appendix 1. If there are omissions or misstatements with regard to the description, the reporting accountants request that they be amended as appropriate. If they are not amended, the reporting accountants consider the implications for their assurance report.

Reporting accountants may provide details of work performed as part of their report.

APPENDICES 1. Principles and related guidance of the UK Stewardship Code

This appendix is based on the specified Principles (1, 2, 4, 6 and 7) and provides a summary of the related guidance contained in the UK Stewardship Code. These are the subject matter of the Policy Statement and related disclosures that are, as a minimum, subject to assurance reporting. The relevant criteria for the fairness of the description of the specified elements of the statement and related disclosures are relevance, completeness, reliability, neutrality and understandability. Asset managers may meet the criteria for reporting by delivering meaningful explanations for non compliance in accordance with the guidance that accompanies the Code.⁴⁶

The reporting accountants evaluate whether the content of the asset manager's Policy Statement is a fair description measured against these criteria.

If, in addition to the minimum contemplated, further assurance is to be provided on design suitability, the effectiveness of process implementation or both, the Stewardship policies are analogous to the control objectives (criteria) described in paragraphs 23 to 26 of AAF 01/06. The reporting accountant evaluates whether these specific criteria are relevant, complete, reliable, neutral and understandable as required by ISAE 3000.

The ICAEW Working Group and the stakeholder panel will monitor the development of practice in this area with a view to developing good practice criteria as appropriate.

Principle 1 – Institutional investors should publicly disclose their policy on how they will discharge their stewardship responsibilities

Institutional investors' policy on stewardship should disclose how the institutional investor applies with the aim of enhancing and protecting the value for the ultimate beneficiary or client.

The statement should reflect the institutional investor's activities within the investment chain, as well as the responsibilities that arise from those activities. In particular, the stewardship responsibilities of those whose primary activities are related to asset ownership may be different from those whose primary activities are related to asset management or other investment-related services.

Where activities are outsourced, the statement should explain how this is compatible with the proper exercise of the institutional investor's stewardship responsibilities and what steps the investor has taken to ensure that they are carried out in a manner consistent with the approach to stewardship set out in the statement.

The disclosure should also describe arrangements for integrating stewardship with the wider investment process.

Principle 2 – Institutional investors should have a robust policy on managing conflicts of interest in relation to stewardship and this policy should be publicly disclosed

Conflicts of interest inevitably arise from time to time, which may include when voting on matters affecting a parent company or client.

Institutional investors should put in place, maintain and publicly disclose a policy for identifying and managing conflicts of interest, with the aim of taking all reasonable steps to put the interests of their client or beneficiary first. The policy should also address how matters are handled when the interests of clients or beneficiaries diverge from each other.

Principle 4 – Institutional investors should establish clear guidelines on when and how they will escalate their stewardship activities.

Institutional investors should set out the circumstances in which they will actively intervene and regularly assess the outcomes of doing so. Intervention should be considered regardless of whether an active or passive investment policy is followed. Instances when institutional investors may want to intervene include when they have concerns about the company's strategy, performance, governance, remuneration or approach to risks, including those that may arise from social and environmental matters.

Principle 6 – Institutional investors should have a clear policy on voting and disclosure of voting activity

A policy covering voting and disclosure of voting activity should be publicly disclosed.

Disclosures should include:

- the use made, if any, of proxy voting or other voting advisory services. They should describe the scope of such services, identify the providers and disclose the extent to which they follow, rely upon or use recommendations made by such services.
- their approach to stock lending and recalling lent stock.

Principle 7 – Institutional investors should report periodically on their stewardship and voting activities

Asset managers should regularly account to their clients or beneficiaries as to how they have discharged their responsibilities, comprising both qualitative and quantitative information in a format agreed between agents and their principals. They are not expected to make disclosures that may be counter-productive as confidentiality in specific situations may well be crucial to achieving a positive outcome.

Asset managers should obtain an independent assurance opinion on their engagement and voting processes, having regard to this Supplement to AAF 01/06. In which instance, they should publicly disclose the existence of such assurance reporting⁴².

⁴² ICAEW guidance on providing access to assurance reports is available from: [icaew.com/en/technical/auditand-assurance/assurance/access-to-controls-reports](https://www.icaew.com/en/technical/auditand-assurance/assurance/access-to-controls-reports).

2. A pro forma reporting accountants' assurance report on the UK Stewardship Code (revised July 2016)

Independent reporting accountants issue an assurance report in a form suitable for the specific engagement. The report below is adapted from a pro forma assurance report (ii) Engagement formed between the reporting accountant and the service organisation only in Appendix 3 of AAF 01/06 for the purpose of reporting in relation to Principles 1, 2, 4, 6 and 7 and related guidance of the UK Stewardship Code.

Independent reporting accountants' assurance report on the [name of entity]'s Statement in relation to Principles 1 2 4 6 and 7 and related guidance of the UK Stewardship Code for institutional investors

To xxxxx (See AAF 01/06 for wording)

Use of report

(Example wordings to describe applicable restrictions on the use of the report, together with supporting guidance on alternative forms of engagement and associated duties of care arising, are set out in AAF 01/06).

Scope

We have been engaged to report on [name of entity]'s statement in relation to Principles 1, 2, 4, 6 and 7 of their policy statement with respect to the UK Stewardship Code for institutional investors published by the Financial Reporting Council ('the Code') as at [date] ('the Policy Statement') as attached to this document in Appendix [...].

Assertion of manager's responsibilities

[Name of entity] is responsible for preparing the description in the Policy Statement of how the Principles of the Code, including Principles 1, 2, 4, 6 and 7 ('the specified Principles') and the specific information requested for disclosure have been applied or an explanation where elements of the Code have not been complied with.

Our independence and quality control

We have complied with the independence and other ethical requirements of the ICAEW Code of Ethics, which includes the requirements of the Code of Ethics for Professional Accountants issued by the International Ethics Standards Board for Accountants, which is founded on fundamental principles of integrity, objectivity, professional competence and due care, confidentiality and professional behaviour.

The firm applies International Standard on Quality Control 1 and accordingly maintains a comprehensive system of quality control including documented policies and procedures regarding compliance with ethical requirements, professional standards and applicable legal and regulatory requirements.

Reporting accountant's responsibilities

Our responsibility is to form an independent opinion, based on the work carried out in relation to the Policy Statement and report this to you as the directors. We conducted our engagement in accordance with International Standard on Assurance Engagements (ISAE) 3000 and with ICAEW Technical Release AAF 01/06 including its Stewardship Supplement. ISAE 3000 and AAF 01/06 require, among other things, that we plan and perform our procedures to obtain reasonable assurance as to whether, in all material respects, the Policy Statement is a fair description of [name of entity]'s policy in relation to the disclosure of specific information listed under the specified Principles. The criteria against which the description of the policy in relation to the specified Principles was evaluated are relevance, completeness, reliability, neutrality and understandability.

Our work involved performing procedures including gaining an understanding of the policies and procedures in place and substantiating the descriptions by obtaining evidence about the presentation of the description required by the specified Principles, and assessing the application of the specified Principles and the disclosure of specific information listed under these Principles. Our work did not

include an evaluation of either design suitability or the effectiveness of process implementation described in the Policy Statement. In addition, our work did not involve consideration of the effectiveness of the [name of entity]'s stewardship policies as the outcomes are not under its control.

Inherent limitations

[Name of entity]'s Policy Statement was prepared to meet the common needs of a broad range of users and may not, therefore, include every aspect of [name of entity]'s activities with respect to its engagement with the companies it invests in. Also, because of their nature, [name of entity]'s processes may not prevent or detect and correct all errors or omissions in discharging its stewardship responsibilities.

Our opinion is based on historical information. The projection to future periods of any information or opinions in this report to any future period would be inappropriate.

Opinion

In our opinion, in all material respects, based on the procedures and criteria described above, the Policy Statement describes fairly the policy of [name of entity] in relation to the specified Principles of the Code and the specific information requested in the guidance to these Principles as at [date].

Reporting Accountants

Location

Date

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