



1st February 2012

Our ref: ICAEW Rep 09/12

Your ref: CP 11/27

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Dear Trevor

**Quarterly Consultation CP 11/27, Chapter 4, Tracing Employers Liability Insurers**

ICAEW is pleased to respond to your request for comments on *Quarterly Consultation CP 11/27*.

We look forward to continuing to engage with you on this matter. In the meantime, please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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## ICAEW REPRESENTATION

### **CP 11/27, QUARTERLY CONSULTATION, TRACING EMPLOYERS' LIABILITY INSURERS**

**Memorandum of comment submitted in February 2012 by ICAEW, in response to the Financial Services Authority's quarterly consultation paper CP 11/27 published in December 2011**

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## INTRODUCTION

1. ICAEW welcomes the opportunity to comment on chapter 4 of the quarterly consultation paper 11/27 and the supporting appendix published by the Financial Services Authority (FSA) on December 2011, a copy of which is available from this [link](#).

## WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 136,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.
3. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.
4. The Financial Services Faculty was established in 2007 to become a world-class centre for thought leadership on issues facing the financial services industry acting free from vested interest. It draws together professionals from across the financial services sector and from the 25,000 ICAEW members specialising in the sector and provides a range of services to them.

## MAJOR POINTS

5. We support the overall policy objective of making it easier for former employees to track down the relevant insurer, and appreciate the fact that you have included us in discussions to consider the role of auditors in achieving this objective. To help our members implement your requirements, we have addressed them at an insurance event we ran last year, in our magazine FS Focus, and have arranged a briefing specifically on this topic later this month.
6. We do have some reservations about the proposed requirements around the register, however. In our response to your previous consultation paper 10/13 we argued that requiring reports on all insurers every year was not a risk-based and proportionate approach. We said that it would be better were the FSA to use the rule requirements backed up with the possibility of enforcement action or skilled persons' reports to ensure that insurers are diligent in preparing their employers' liability register. Were this approach not to be adopted because the routine involvement of reporting accountants was considered to be necessary by the FSA, our second preference was for agreed-upon procedures to be used (ICAEW Representation 86/10). Whilst we recognise that the FSA has chosen a different route, we still think the approach we recommended then would be preferable to the regime you are implementing.
7. In our previous response, we also said that the case for an assurance requirement was not explicitly costed in the cost-benefit analysis and said that any proposals the FSA seeks to bring forward should be reconsulted on with an explicit cost-benefit analysis. Whilst some costs are included in this consultation, we have not seen strong evidence that the costs and benefits of approaches involving no routine involvement by reporting accountants; using only agreed-upon procedures or of requiring a limited assurance approach, have been fully considered by the FSA.
8. We use the word 'auditor' in our response as this is the language you use in the consultation paper. However, we also refer to the 'reporting accountant'. This is a clearer title, given that the accountant is not performing an audit and need not be the insurer's statutory auditor.

## RESPONSES TO SPECIFIC QUESTIONS

**Q4.1: Do you agree with the proposed change in the required director's certificate and the definition of 'materially compliant'? If not, what would you suggest and why?**

9. We agree that it is preferable for the directors' certificate to deal with material, as opposed to absolute, compliance as in practice it is unlikely directors would be able to make an absolute statement of compliance. The FSA will be the main user of the directors' certificates, so a clear articulation of your tolerance for error is both appropriate and useful. We agree that it is a somewhat arbitrary approach. As you are aware, 99% is a high threshold and will mean that the costs of achieving material compliance will be greater than if the threshold were to be set at 95%. It also increases the likelihood that firms with known omissions from, or errors in, their registers may fail to be materially compliant, as the size of the register will grow each year and it will become a larger project to manage.

**Q4.2: Do you agree with the proposed form and scope of the qualified director's certificate required to be made if an unqualified certificate cannot be obtained and the transitional provision for one year concerning whether a firm is unable to obtain information out of its control is in breach? If no, please explain.**

10. We find the proposed requirements at paragraphs 4.24 and 4.25 to be inconsistent, as the first paragraph sets out that a firm will be deemed not to be in breach, but the next paragraph goes on to say that the director's certificate and reporting accountant's report would not have regard to the transitional provision. We suggest that a more consistent approach would be for the directors' certificate and reporting accountant's report to specifically state that the firm "has taken advantage of the transitional requirements" and comment on the level of compliance under them.
11. We agree that it will be difficult in some cases to estimate the number of policies affected (ICOBs 8.4.4AR(2) – (3)), and we do not consider this information will be relevant to those seeking to trace an insurance policy. Accordingly, if the certificate is to be widely available (see also our response to Q4.3) we believe this information should be provided privately to the FSA and not included in the directors' certificate. In addition, we consider that details of the steps, with relevant timescales, that the firm is taking to ensure material compliance would also more appropriately be reported privately to FSA rather than being included within the directors' certificate.
12. We note that the rules require details of systems and controls used in the production of the register to be provided only when a director's certificate is not materially compliant (ICOBs 8.4.4AR(4)). We do not see why this information is only required on non-compliant director's certificates, and think it should be required for all, or none. Given that we do not think the overall approach you are proposing is proportionate, our preference would be to simplify the reporting regime where possible, so we would suggest that you do not require this information at all in the certificates, but ask for it on a case-by-case basis.

**Q4.3: Do you agree with our proposal that all directors' certificates should be submitted to us within three months of the date of the ELR to which they relate and that they should be made available, on request, to persons needing to be aware of the level of accuracy and completeness of the ELR? If not, please explain.**

13. Some companies might want to take advantage of the flexibility to move reporting dates, and align the period to which their employers' liability register (ELR) directors' certificate relates to with their accounting period. In this case, a longer reporting period would be useful, so that the work does not have to be completed at the same time as the statutory audit and other regulatory returns.
14. We therefore recommend that the reporting deadline is extended from three to four months from the period end. This is the same period as the FSA prescribes for certain other reporting

requirements (for example reports on client money) and would give insurers who align reporting dates with their accounting period, and their auditors, a month after the due date for the insurance annual return to finalise reporting on the ELR. We do not think an additional month would create a problem for users of the registers, as a majority of them would be seeking information about policies which date back several years.

15. The fact that the FSA is still in consultation means that effective advance planning by insurers and their auditors has not been possible as there is uncertainty as to the requirements that will apply. Therefore, for the first year only, we recommend an extended deadline of six months to facilitate better preparation.
16. Other than the regulator and the Employers' Liability Tracing Office (ELTO), we do not know who will need to be aware of the level of accuracy and completeness of the ELR. We cannot see how it will be helpful information for individuals trying to track down a specific policy, as it will not increase the success of their search. We would need to better understand the benefits of making this information more widely available before we could support it.

**Q4.4: Do you agree with the proposal that, in the long term, independent assurance reports should be prepared by the auditor on a limited assurance basis addressing the risks specified?**

17. No, we are not convinced that an annual reporting requirement is necessary for all firms with these types of policies. We would prefer to see the registers established and the tracing office commence operation first; if its operations were largely successful, the work proposed may not be necessary. Given that the FSA has determined it is, our preference is for agreed-upon procedures to be performed addressing the specified risks and setting out the results of the work, as we consider this will be more useful than a limited assurance opinion.
18. Our observations on the cumulative nature of the register under 'Additional Comments' below are an additional reason for our preference for an agreed-upon procedures approach.
19. Paragraph 4.28 states that "As ELRs are derived from records of recent processing that has been subject to existing controls and audit procedures, we consider it appropriate for the limited assurance engagement on ELRs to address the risks of inaccurate or incomplete extraction from the underlying records to the ELR, and of invalid information contained on the ELR". It is for the FSA to determine what, if any, work should be performed to address the risk of error or omission in the insurer's underlying records. However, we would highlight that the work performed for external audit purposes would have been designed solely for the purposes of forming an opinion on the financial statements; these audit procedures would not have been designed to, and it should not be assumed that they would, identify any errors in, or omissions from, the data contained in the insurers' underlying records which could lead to the ELR not being prepared in accordance with the applicable rules.
20. We are concerned that the proposals in the consultation are unclear in important respects, specifically the FSA's expectations concerning completeness of the underlying records from which the register is compiled and the type of work to be performed on systems and controls. Taking completeness first, paragraph 4.29 (7) indicates that "missing or invalid information which is required to be on the register regardless of what the firm holds on its underlying systems (ERNs, subsidiaries)" should be addressed by the auditor. As noted in the preceding paragraph it is for the FSA to determine the extent of the auditor's work, however, we believe it is likely to be difficult and expensive to establish completeness of the underlying records. A more proportionate approach might be for the auditor to focus on the extraction of information from the underlying systems to the register. Arguably it would be disproportionate to require the auditor to validate the data held on the underlying systems to either other data that may be held by the insurer (e.g. hard copy application forms) or to third party sources.

21. The procedures at 4.30 will not address the risks of the insurers' underlying records being incorrect, as the 'systems and controls' around the register would typically not include all the underlying systems and information. It is important the FSA clarifies its expectations in this regard.
22. The draft rule (ICOBS 8.4.4CR) setting out the form of the reporting accountant's report needs to be aligned to the intended scope of their work. In particular, if the intention is that the reporting accountant addresses only the extraction of data from the underlying systems then ICOBS 8.4.4CR(1) needs to reflect this specific scope rather than referring to material compliance with the rules more generally. In addition, we do not believe it is appropriate for ICOBS 8.4.4CR(3) to refer to matters that the auditor must 'in particular' have regard to and address; the auditor's work must be sufficient to provide the opinion that the auditor is required to give and it will be for the auditor to determine the scope of the work necessary to achieve this.
23. We note the numbered list at paragraph 4.29 starts at number 3, and understand this is a typographical error rather than an omission.

**Q4.5: Do you agree with our proposal to require reports by auditors to be submitted to us along with directors' certificates within three months on the date of the ELR to which they relate? Do you agree that they should be available to qualifying tracing offices on request if the insurer is using the tracing office to make its ELR available or if the tracing office is obtaining information from the insurer for the purposes of offering a comprehensive tracing service? If not, please explain.**

24. We refer you to our answer to question 4:3 above for the timing of returns.
25. The reporting accountant's report is addressed to the directors, but will also be used by the FSA. This is an arrangement which is currently taken for other types of assurance on regulatory returns. We note that the introduction of an additional third party, the tracing office, will give rise to additional considerations, for example as it will be difficult for audit firms to communicate how their report can be used by the tracing office where the directors, rather than the audit firm, send a copy of the report to the tracing office. Accordingly, making the report available to the tracing office may be seen by audit firms to increase the potential liability they are accepting, with implications for the manner in which they price this work. The reporting accountant's report may need to include wording setting out to whom a duty of care is owed, the fact that the tracing office has not set the scope of the work, and that the user should be reasonably informed such that they would know the purpose of the report and what work had been done (or not done) in order to provide it.

**Q4.6: Do you agree with our proposal to retain the requirement for auditors to satisfy the requirements of SUP 3.4 and SUP 3.8.5R to 3.8.6R? If not please explain.**

26. Yes.

**Q4.7: Do you agree with the proposed transitional provisions to allow firms to comply with the current rules regarding directors' certificates and reports for ELRs as at 1 April 2012? Do you agree that reports should be allowed to be prepared on the basis of agreed-upon procedures complying with an FSA framework? If not, please explain?**

27. Yes, as if regular reporting on all insurers' registers of employers' liability policies is to be required, we would support the use of agreed-upon procedures to check them every year. Consistent with our preference, we agree that they should be used during the transitional period. Our preference would be for this approach to be adopted on an on-going basis, not just in the transitional period, as we think it will furnish the FSA with more useful information and be more cost effective than will a limited assurance report.

28. We are concerned that where firms have problems with their registers in year one, they may struggle to correct these as the registers grow. A longer transitional period may be useful for some firms.
29. We do not welcome a bifurcated approach of agreed-upon procedures for registers that are not materially compliant, and limited assurance for those that are, which was amongst the options the FSA has considered recently. However, despite our reservations we would prefer this to qualified limited assurance opinions being given on what may be a significant number of non-compliant firms. Where directors are already aware that they are not in compliance and are reporting this themselves to the FSA, a limited assurance report would not provide additional useful information. As we have already explained, our preferred risk-based approach was to use section 166 powers in individual firms (for example, where non-compliance was suspected, where large numbers of these policies are held, or where a few policies with significant exposures are held) with agreed-upon procedures for all firms being our second option.
30. We refer you to our response to question 4:3 above on the timing of the first certificates and reporting accountants' reports.

**Q4.8: Do you agree with the proposed FSA framework for determining agreed-upon procedures permitted to be used by auditors in producing reports for ELRs as at 1 April 2012? If not, please explain.**

31. As you are aware, we have submitted suggestions as to what procedures might be relevant to the register, and we are pleased that some of our input has been captured in the FSA's proposals.
32. However, we think the existing proposals need to be clearer. In our view, these substantive tests should focus on how the specific information has been extracted from the underlying records to the register. The results of the substantive procedures then indicate whether the controls and systems are operating in a satisfactory manner. We do not think the substantive tests themselves should be part of a systems and controls assessment; this means that we would delete references to 'evidence of internal controls operating effectively' at paragraph 4.42, the second sentence of paragraph 4.43 and the reference to 'systems and controls' in Transitional Provision 8B(2)(b)(iii).
33. It is not clear to us how the sample sizes were derived, so we cannot comment whether they represent a statistically valid approach for the level of comfort sought by the FSA.

**Q4.9: Do you have any comments on our cost benefit analysis for our proposals for the director certification and reports by auditors on ELRs?**

34. Due to the ambiguities we have identified around the scope of the auditor's work (extraction only or underlying data, and all relevant systems and controls), the costs you have identified may not be complete. If controls and systems work is to be performed and underlying data to be checked, the costs would be higher.
35. We do not agree with the assumption, set out in paragraph 4.51, that the costs of limited assurance engagements would be similar to the costs of initial reports performed on an agreed-upon procedures basis. We think that a limited assurance approach will be more expensive. We understand that the costs you identify and attribute to a limited assurance engagement in paragraph 4.50 were based on data relating to an agreed-upon procedures approach; as a result we do not concur that these costs represent a reasonable estimate of the costs of a limited assurance engagement.

36. We note that the fee structure you present for a typical 100 hours has five tiers of staff involved; some audit firms have indicated to us that they would expect to have fewer layers of management involved. The pricing structure would therefore be different to the one in your analysis.
37. We note that the proposals are expected to increase insurers' payouts and reduce those made by the government. The proposals will also see costs increase for insurers with these policies as they will need to meet the certification requirements. We wonder whether the cost benefit analysis should have included mention of the fact that the cost of employers' liability insurance is likely to increase for employers, as insurers are likely to pass on the increased costs associated with these policies. Whether smaller suppliers or new entrants will be deterred from providing these types of policies might also have been considered.

**Q4.10: Do you agree with the proposal that the independent assurance report for qualifying tracing offices should be prepared on the basis of the auditor providing the 'reasonable assurance' opinion stated? If not please explain.**

38. The extent to which the auditors of the tracing office can rely on the work performed on the firms' registers will affect the amount of work an auditor would need to do and the type of opinion he or she could give. It will be important to avoid duplication of work already performed at the level of the insurers' registers. Generally, it will be more efficient to review the accuracy of information kept centrally by the tracing office than to look in detail at each individual register: we recommend that you consider whether your proposals will be efficient in this respect.
39. As there may in practice be only one tracing office, we recommend a framework that allows the office, its auditor and the FSA to establish the level of assurance the office and FSA will require.
40. Thought should be given to what will happen in years when the tracing office receives a qualified or otherwise modified opinion from its auditor. Depending on the reason for the qualification, it may be in the public interest to allow insurers to continue to use the tracing office.

**Q4.11: Do you agree with our proposal to incorporate the current modification by consent regarding co-insurance in our rules and guidance? If not, please explain.**

**Q4.12: Do you agree with our proposal to incorporate the current modification by consent on excess insurance in our rules and guidance and require firms who take advantage of our proposal to notify us if they provide excess insurance? If not, please explain.**

**Q4.13: Do you agree with our proposed definition of 'claims made' and the transitional period of one year to allow firms to adapt their systems?**

**Q4.14: Do you agree with our proposal for all ERNs of companies covered to be included on ELR registers and the transitional period of one year to allow time for firms to adapt their information collection processes?**

41. We do not wish to offer a response to questions 4.11 through to 4.14.

## **ADDITIONAL COMMENTS**

42. Were the auditor to be required to give one, a limited assurance opinion would apply to the register as a whole. The cumulative nature of the register makes it different from other information auditors typically look at. We envisage problems when an insurer decides to (or, if



current EC proposals are enacted, is required to) change its auditor some years into the life of the register. The incoming auditor would not have a statutory right to look at the outgoing auditor's working papers as it does not form part of the statutory audit of financial statements. Even if they did have such a right, there would be a considerable cost burden on the insurer as each successive auditor would have to go back and review the papers for earlier years as their opinion, for which they are solely responsible, would rely on this earlier work. Furthermore, as the registers are intended to have very long lives, auditors are unlikely to retain their working papers over the entire life of the register. An agreed-upon procedures approach is likely to be able to accommodate changes in the firm performing the work more readily.

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