

broking**business**

Company fraud

Audit responsibilities

Sharing the load

Guide to apportionment
and oversight

The enhanced business review

Can it enhance
your business?

Welcome

Regulations! Regulations! Regulations! you might cry (again). The implementation of new Companies Act requirements in particular has been accompanied by much groaning throughout the sector. On the bright side, having to scrutinise more closely what you do can bring many unforeseen benefits and, of course, CLB Littlejohn Frazer is on hand to help.

With this in mind, David Roberts guides you through the enhanced business review (essentially giving a higher profile to an assessment of risks and key performance indicators) that's required now for the directors' report in financial statements.

We also report on the fact that new regulations now govern the way in which both auditor and directors examine the risk of fraud within companies. Closer controls are no bad thing when you consider that fraud is a growing problem in the UK and insurance brokers ignore it at their peril.

With so much to think about, the article by John Gregson of Neo Consultancy on the rules governing the apportionment of management responsibilities, as laid down by the FSA, may be rather timely.

If you would like further guidance on these or any other broking topics, CLB Littlejohn Frazer would be pleased to hear from you. Contact one of the team or email broking@clblf.com

In brief



John Needham

John is a manager in the firm's financial services division, specialising in insurance. He is also a member of the broking team, which caters for the needs of insurance brokers and other intermediaries.

TCF compliance

Now that the FSA's deadline of 31 March has passed, all regulated General Insurance firms should be well on the way to implementing their Treating Customers Fairly (TCF) policy in substantial parts of their businesses. By now, you should have:

- Appointed a senior member of your team to lead your firm's TCF initiative
- Defined what TCF means in your firm
- Completed a 'gap analysis' to establish what still needs to be done
- Timetabled the actions required to 'close the gaps'
- Started the implementation process

Client money review

Recently released findings from the FSA's review of how firms handle client money have highlighted a number of common failings. While the overall message is positive, some of the enforcement cases involving firms that have failed to comply with client money rules make scary reading.

The FSA advises all firms that handle client money to read the findings to ensure they are aware of the issues involved and avoid the potential pitfalls.

To read the detailed findings, please visit: http://www.fsa.gov.uk/pages/Doing/small_firms/insurance/library/client_money_detail07.shtml

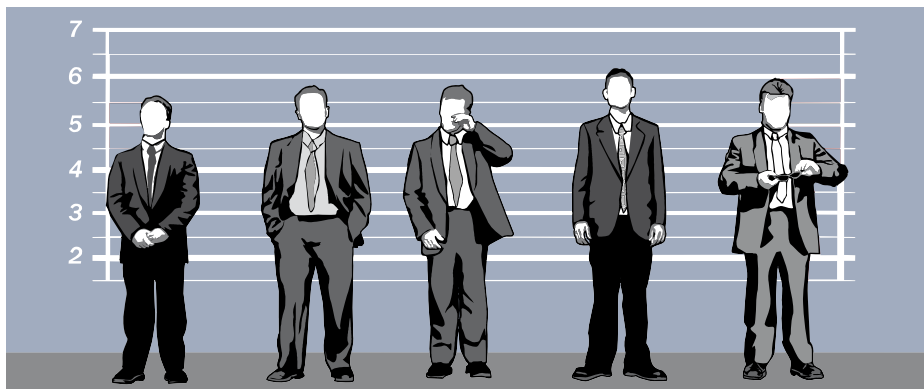
The consolidator

We have all read with interest about the acquisition of Stuart Alexander and Layton Blackham by AXA UK plc, via its investment vehicle, Venture Preference Limited.

Layton Blackham (LB) has released a revealing briefing paper outlining what the deal means for stakeholders. The paper also addresses the independence and conflict issues that have been the cause of much comment in the marketplace. We wonder how it is going to work on a practical basis – however, LB's brief certainly seems to send out the right messages. If LB can still operate truly as an independent, then having the security of AXA behind it can only be a good thing.

Fighting fraud – your responsibilities

Are you and your auditors discussing fraud? It's a key and growing issue, which insurance brokers ignore at their peril. Jessica Wills reports



Jessica Wills

Jessica is an audit manager in the firm's financial services division and a member of the broking team.

The implementation of the international auditing standard on auditors' responsibility to consider fraud (ISA 240) reinforces the fact that auditors must consider fraud during their audit of a firm's financial statements. Linked to this is the duty of, among others, auditors to report any actual or suspected fraud to the Serious Organised Crime Agency.

However, the primary responsibility for the actual prevention and detection of fraud lies with those who govern and manage the company (the Board and senior management).

Under the Companies Act 2004, directors are responsible for providing all relevant audit information, including that relating to fraud, to their auditors and a statement to this effect must be disclosed in the directors' report.

What is fraud?

ISA 240 defines fraud as 'an intentional act by one or more individuals among management, those charged with governance, employees or third parties, involving the use of deception

to obtain an unjust or illegal advantage'.

This article is concerned with risks of financial statement 'misstatement' arising from fraud carried out by those charged with management, governance or employees (internal fraud).

What you need to know

You must be able to demonstrate to your auditors:

- Your assessment of risk of financial statement 'misstatement' arising from fraud
- Your process for identifying and controlling these risks
- Your communication of this process within the company
- Your knowledge of any actual, suspected or alleged fraud

As well as having a detailed fraud risk assessment and details of the internal controls in place, the prevention and detection of fraud needs to be embedded within company culture to reduce the assessed risks. Your auditors will also check things like:

- Is there a written fraud policy, communicated within the

company, including whistle-blowing procedures and protection?

- Is fraud included within the scope of the internal audit and/or compliance function?
- Is there a Board and/or Audit Committee member charged with overall responsibility for fraud prevention and detection?
- Is fraud discussed as a standard agenda item at Board and/or Audit Committee meetings?
- Are there written recruitment and employment procedures to prevent fraud? For example, obtaining references, criminal records checks, fraud training and inclusion of responsibilities for the prevention and detection of fraud within job descriptions?

On page 6, we highlight some of the key areas to consider in an internal fraud risk assessment and control, and when discussing fraud with your auditors.

For further information, please contact Jessica Wills at CLB Littlejohn Frazer on 020 7369 4529 or email jwills@clbhf.com

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Apportionment that

Sharing the management load – the FSA's apportionment rules and how *your* firm can demonstrate compliance.

The role of senior management in regulated firms remains an area of prime focus for the FSA in 2007. The FSA has mandated specific rules that must be followed to ensure regulatory compliance and provide the regulator with confidence that a firm is properly managed. In particular, the FSA needs to see evidence that senior management responsibility is encouraged.

Although the regulator is moving towards a more principles-based approach to regulation, the requirement for you to demonstrate that you manage your business properly will always be there.

What is the starting point?

Each firm will organise its business in a way that suits its needs and those of its clients and other stakeholders. In determining how to share out (or 'apportion') the responsibilities of management of the firm, the starting point is to articulate exactly what these responsibilities are and what they mean in practice.

The FSA's Principles for Business and Systems and Controls (SYSC) rules point the way. The requirements effectively translate into some 17 regulatory areas, including:

- Governance standards
- Organisation, reporting lines and delegation
- Business strategy and budgeting
- Financial control
- Management information

- Staff recruitment, training and management
- Treatment of clients
- Risk management

For each area, firms need to decide what state of affairs (or 'intended outcome') would give them confidence that regulatory compliance is being achieved. By way of example, for some firms, a suitable outcome for 'Staff recruitment, training and management' might read:

'ABC ensures that all members of staff performing regulated activities are suitable to fulfil their duties: that is they are, and remain, fit and proper and have, and continue to have, the appropriate competences (defined as a combination of knowledge, skills and behaviours) for their allocated roles'.

What next?

As a regulated firm, you will have had to nominate various Approved Persons to roles known as 'Controlled Functions'. The 'Apportionment and Oversight' function (CF8) is often taken by the CEO or equivalent because the CEO remains personally accountable to the FSA for the proper running of the firm. However, the FSA recognises that it is impractical for one person to accept responsibility for everything, so it encourages the apportionment of the CEO's responsibilities amongst Approved Persons and other senior management in the firm.

The CEO must decide and document who, within the firm, will take responsibility for which area(s) and then formally

announce this. Whilst it is permitted for a particular area to be apportioned to several people, this should be carefully documented to ensure that there is a clear division of responsibilities. There is no bar to one person having more than one responsibility apportioned to him or her. To complete this stage, each individual to whom an area has been apportioned should have this recorded in his or her job description.

How do those with apportioned responsibilities demonstrate compliance?

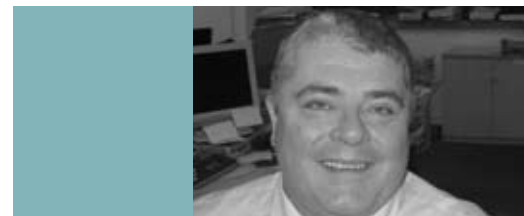
We suggest each intended outcome is defined in a set of 'confidence statements'. These should set out the behaviours or other evidence that might demonstrate that the apportioned responsibilities are being managed effectively. Such statements can then be challenged or supported by the business. Continuing our 'Staff recruitment, training and management' example, the statements might include:

- ABC has identified and documented the competency requirements of each job and keeps these up to date
- ABC has identified and documented its goals for individuals, to enable them to demonstrate their fitness and propriety to work towards them
- Appropriate and proportionate checks are made to establish the fitness and propriety of each staff member in a regulated role

Those with apportioned responsibilities may need to take soundings from various



measures up



John Gregson

With 30 years in the General Insurance industry, John Gregson of Neo Consultancy currently advises firms on their FSA compliance. In 2006, he was appointed a Special Adviser to the FSA.

colleagues before they can respond to each confidence statement. They may even choose to delegate the responsibility for forming the view. This is perfectly acceptable, provided that the delegation has been documented. In our example, an external agency might be engaged by your HR team to perform background checks on staff.

Depending on the findings, confidence would be measured on a simple High/Medium/Low scale.

Does it stop there?

No. Each individual should formally report their findings to the CEO. Being personally accountable to the FSA for the proper running of the firm, the CEO should ensure that action plans are in place for each

area where improvement and monitoring is required. A report should be made to the Board and progress should be minuted.

What are the benefits to my firm in adopting this approach?

Firstly, maintaining the FSA's confidence in the area of apportionment and senior management responsibility plays a key role in determining your firm's suitability for continuing authorisation.

Secondly, firms that have adopted this approach have experienced an improvement in the commitment to regulatory compliance by their senior management team because compliance ceases to be 'someone else's responsibility'. Commitment from the 'top' quickly filters through to staff out of necessity and, ultimately, firms have been able to demonstrate an improvement in their service to clients.

CEO's 10-point checklist

- ✓ I have issued a formal statement to members of my senior management team explaining the apportionment process and how it works
- ✓ I have articulated what my responsibilities are
- ✓ I have defined what those responsibilities actually mean
- ✓ I have determined which members of my senior management team will share my responsibilities and what will be allocated to whom
- ✓ I have obtained the 'buy-in' of my senior management team
- ✓ Job descriptions of those with apportioned responsibilities contain reference to the responsibilities I apportion to them
- ✓ I know what regulatory success looks like in my firm against each of my responsibilities
- ✓ The process I have established enables me to assess at appropriate intervals whether or not the systems and controls in place in my firm are compliant with regulations
- ✓ Action plans exist to address areas of weakness
- ✓ The process I have put in place is supported by a fully documented procedure

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Fraud – risks and controls

This table highlights ten key areas of an insurance broker's business that have an impact on the financial statements. For each area, we have considered examples of internal fraud risk factors (events or conditions that might encourage someone to commit fraud), examples of internal fraud (including both the misappropriation of assets and fraudulent financial reporting) and suggested controls.

No	Area	Example fraud risk factors	Example of misappropriation of assets/fraudulent financial reporting	Suggested controls
1.	Revenue recognition	Internal/external pressures to achieve budgetary targets, employee performance-related remuneration, dominant owner management	Manipulation of income or costs such as: <ul style="list-style-type: none"> • Double counting of brokerage in one year • Unsupportable credits or releases of balance sheet provisions 	Board and/or Audit Committee review and approval of accounting policies and their application
2.	Brokerage/fee income	Internal/external pressures to achieve budgetary targets, employee performance-related remuneration, dominant owner management	Recognition of brokerage/fee income for work not performed	Management review and approval of broking files, independent internal audit/compliance file reviews
3.	Profit commissions receivable and performance-related income	Commission-driven nature of business, internal/external pressures to achieve budgetary targets, employee performance-related remuneration, dominant owner management	Manipulation of results for receiving profit and performance-related income from insurer	Board and/or Audit Committee review of profit commissions and performance-related income. Self review for internal conflicts of interests.
4.	Renewals	Dominance of and reliance on key clients/policies	Non-disclosure of adverse claims information to insurer prior to renewal of a policy, to secure renewal and brokerage income	Management review of broking and claims files relating to renewals of key clients/policies
5.	Third party commissions payable	Inadequate internal control over payment of third party commissions payable, personal financial obligations, adverse relationship between company and employee	Payment of third party commissions payable to personal bank accounts	Formal documentation of commission-sharing arrangements, management review and approval of commissions payable, segregation of duties over the processing, authorisation and payment of commissions payable and bank reconciliations
6.	Employee expenses	Inadequate internal control over authorisation of expense claims, personal financial obligations, adverse relationship between company and employee	Fraudulent expense claims, including claims for personal expenses (e.g. for taking spouses on business trips without authorisation)	Segregation of duties over the processing, authorisation and payment of personal expenses and bank reconciliation, independent oversight of management expense claims
7.	Accounting records	Existence of unreconciled suspense accounts in accounting records	Expense accounts are used to hide certain transactions that might give rise to an adverse result	All suspense accounts should be reconciled and cleared on a monthly basis
8.	Off balance sheet liabilities	Existence of claims against the company	Non-disclosure of potential claims against the company, which may result in financial loss	Regular management meetings to assess indicators of potential claims
9.	Client money	Client money reconciliations showing deficit in client funds, corporate transactions in client money accounts, unearned commission figure being excluded from the client money reconciliation	Client assets used to fund corporate activities	Ensure that full client money calculation is carried out in accordance with the FSA rules and reviewed by a responsible individual
10.	Debtors	Existence of old debtor balances	Non-disclosure of irrecoverable debtor balances	Segregation of duties between client relationship manager and credit control

Paint a picture of your business

The enhanced business review is a new Companies Act requirement. David Roberts, head of broking, suggests it's not another administrative burden but allows firms to 'paint a picture' of their business.



There is now a new Companies Act requirement to produce an enhanced business review, which is essentially an assessment of the performance of the business by reference to business risks and key performance indicators (KPIs). This is to be included in the directors' report in a company's financial statements.

Below are some factors to consider, as well as the minimum disclosure that intermediaries might include.

Does this apply to you?

The new requirements apply to all UK companies, but there are size exemptions. A small firm

is exempt from all disclosure, while medium-sized firms are exempt from non-financial KPI disclosures. The basic criteria, taken from s.246 of the Companies Act 1985, are shown below. If a firm breaches any two of these criteria then it is deemed to have breached the size criteria.

What data to include

Most of the KPIs you might include in the business review may be derived from figures that are available elsewhere in the financial statements.

Other KPIs, such as non-financial ones, might be taken from management information

Criteria	Balance sheet total (gross assets) £(m)	Turnover £(m)	Employees
Small	Not more than 2.8	Not more than 5.6	Not more than 50
Medium	Not more than 11.4	Not more than 22.8	Not more than 250
Large	More than 11.4	More than 22.8	More than 250



David Roberts

As a partner in the firm's financial services division and head of the broking team, David specialises in advising the London insurance market. He is a regular commentator on market activity in the insurance press.

Financial KPIs

- Return on capital employed (ROCE)
- Dividend yield
- Operating profit margin
- Turnover
- Investment return
- Net margin
- Commentary on p/e ratios (if quoted)
- Commentary on the net asset position in the context of financial strength

Non-financial KPIs

- Ratios relating to staff numbers (e.g. brokerage per head)
- Happiness measures (e.g. staff turnover rate)
- Staff growth rate (e.g. new teams)
- Management control indicators (e.g. comparison to budgets and forecasts. Implementation of new systems)
- Environmental measures (e.g. commentary on carbon footprint)

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that is currently only produced for internal use. Before including such information, you should ask whether it could be too sensitive to release to the outside world. For example, might your staff turnover rates or other 'happiness measures' raise a few eyebrows? You should also consider the sources and hence reliability and accuracy of non-financial information.

Year-on-year performance

Use KPIs to paint an honest and fair picture of your business. Consider KPIs that reflect your business objectives, such as growth, cost or regulatory targets. Be warned though that if you include a KPI in one year to highlight exceptional performance, it may highlight performance that is not so exceptional in the following year!

“
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 ”

Below are the basic business risks that might be referred to in an enhanced business review for an intermediary.

Inadequate business volume

Whether due to loss of clients, loss of placing markets, pricing pressures or other market conditions, loss of business volume at the top end is a key risk. It is also, perhaps, the hardest business risk to mitigate against. When considering business volume, comment on growth, new business wins or losses as appropriate.

Investment/interest rate risks

Most brokers have relatively low investment risk due to the nature of their investments. However, if the interest earned forms a significant part of your profit margin, a risk of a lower return may have a significant impact, so commentary on investment strategy would be appropriate.

Liquidity

Brokers often operate in seasonal environments and there are tight periods during the year. If your business is seasonal, then a mention of your cash flow forecasting and budgeting would be appropriate.

Exchange rate risk

For some brokers, the US dollar will have hit hard in 2006. If you are exposed to exchange rate

fluctuations, a description of your mitigation strategy should be included.

Credit risk

Brokers can run significant credit risk if they fund, or are subject to, onerous settlement terms in specific markets. If this applies to you, a description, for example, of your view on funding and credit control would be appropriate.

Regulatory

As intermediaries are operating in a regulated environment, you should make a statement regarding your approach to regulation and how you ensure compliance with regulatory requirements.

Operational

Firms are always exposed to operational risk, such as IT failures or loss of key staff. You might make appropriate comments on key mitigating factors, such as disaster recovery or staff incentive schemes.

If you would like to talk through any issues relating to business risks facing brokers, or KPIs, please contact David Roberts on 020 7369 4551, email droberts@clblf.com

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Our dedicated financial services division offers extensive experience and expertise. Our particular strength is in the London insurance market, where we have worked for over 100 years. In this time, we have built up a comprehensive business and technical understanding of the workings of the industry, backed by detailed and practical knowledge of the unique challenges and issues faced by the insurance market.

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