Consultation: Reporting Accountant
Proportionate Regulation: Changes to Reporting Accounting Requirements

ICAEW welcomes the opportunity to comment on the consultation paper *Proportionate Regulation: Changes to Reporting Accounting Requirements* published by the Solicitors Regulation Authority (SRA) on 7 May 2014, a copy of which is available from this link.

We regret the unusually short timescale provided for responses (only six weeks) and the very imminent proposed implementation date of October 2014. Such a short timescale inevitably means that the SRA is unlikely to benefit from many informed views on the proposals, particularly from representatives of the clients of solicitors who are likely to be the most direct losers from any misuse of client money and from the legal profession in terms of loss of reputation, increased funding needs for the Solicitors' Compensation Fund and impact of additional responsibilities for COFAs. Notwithstanding our concerns, we have sought to consult as widely as possible with our members in both business and practice who have explicit knowledge of this area of work.

This response of 17 June 2014 has been prepared on behalf of ICAEW by the Audit and Assurance Faculty. Recognised internationally as a leading authority and source of expertise on audit and assurance issues, the Faculty is responsible for audit and assurance submissions on behalf of ICAEW. The Faculty has around 7,500 members drawn from practising firms and organisations of all sizes in the private and public sectors.

This ICAEW response reflects consultation with the ICAEW Solicitors Group. The Solicitors Group Committee is made up of experts in solicitors' accounts from accountancy practices and those working in industry. The committee benefits from working relationships with other bodies and interested parties in the legal environment. The special interest group provides support to members including newsletters, events and networking opportunities available through icaew.com/solicitors

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MAJOR POINTS

Supportive of objective of proportionate regulation

1. We welcome the objective of finding better and more effective ways to protect client money. We agree with the SRA's desire that regulation and the management of risks should be 'proportionate' and 'targeted'.

The current system of reporting is not the most effective use of our members' skills

2. The SRA Accounts Rules and the current system of reporting have remained fundamentally unchanged for many years. We do not believe that 'the one size fits all' approach to reporting under the existing Accounts Rules meets the SRA's needs and neither is it the most effective use of the skills of our members. The existing report is backward looking, does not lead to an effective risk-based approach or allow for the use of professional judgement by accountants. But as it stands, it is the only external intervention that firms of solicitors currently encounter.

The SRA should focus on identifying and addressing the key public interest risks and cost issues it faces

3. We believe that there are much broader and more fundamental public interest and cost-related issues that the SRA should address here; the effectiveness (including cost) of the accountant's report requirement is a mere symptom of these wider issues. We believe that if the SRA is clear about its ultimate goals it needs to approach this with greater and bolder vision.

4. Our view is that the Accounts Rules are not fit for purpose and they no longer meet the SRA's needs. The introduction of Outcomes Focused Regulation (OFR) has made the Handbook more principles and outcome-based but the Accounts Rules are out of date and very prescriptive. Our members have been expressing concerns about their inflexibility and complexity and their clients' lack of understanding of them for many years.

5. The SRA should focus on what regulation is needed in order to meet its objectives to protect consumers of legal services. Alongside this, it should also be assessing the greatest costs to itself, the Law Society, law firms and their clients and how these costs might be mitigated. After a thorough investigation of all the issues it should then set in place regulatory requirements that address these issues. Part and parcel of this is, of course, the consideration of what external assurance might be necessary to support this. The removal of the accountant's report requirement alone, however, will not address these wider issues.

Protection of the public interest should be paramount

6. OFR has the protection of client interests as its main objective. There is a clear public interest in ensuring that there is robust regulation of solicitors' client accounts, given the prevalence of payments entrusted to solicitors (in corporate finance transactions as well as in property and in probate). If one looks at why solicitors are struck off, misuse of client monies is a frequent cause. We have seen enough examples of problems in other sectors with client monies to indicate the damage that can be done, sometimes to vulnerable individuals, and this is very relevant for solicitors dealing with trusts and probate.

7. An independent external review will have been valuable to clients of law firms who may have had concerns about placing their money in the care of the law firm. Given this, we would have expected to see far more details in the consultation paper for consumers about the alternative arrangements that the SRA intends to put in place and the risk indicators that they will be looking at, in order to demonstrate how they will protect the interests of consumers. For instance, the proposals refer to requiring reports if certain 'risk circumstances' are present or where there are 'problems with client money' but they do not provide any detail about these circumstances or problems or how they will seek to identify them.

8. These proposals run contrary to recent changes implemented by other regulators in this area that tighten up the requirement for external review over client monies (some examples of these

are given in paragraphs 25 and 47 below). As this is the case, we would expect to see greater consideration of these approaches and justification for taking these steps than is currently included in the paper.

9. These proposals appear to be similar to the 'self-certification' introduced by the Law Society of Scotland around 10 years ago. Clearly there are differences in legal systems and approaches but presumably the SRA has had good feedback from them (and other regulators such as RICS) that have introduced similar deregulatory measures) about how this works in practice. Again, there is no reference to this in the consultation.

10. While the SRA may not have found the accountant's reports helpful, the requirement to have one will have acted as a very valuable deterrent to certain firms using the client money inappropriately. Equally, accountants will also have had certain whistleblowing responsibilities that must have provided further comfort. We do not believe that the consultation paper gives these points due consideration or prominence. For instance, despite the acknowledgement in paragraph 16 that misuse of client money is a key risk, the consultation paper does not consider any alternative external review options that could help to reduce costs to law firms and the SRA. There is significant scope for far more forward looking, lighter touch or risk focused reviews and we would be very happy to discuss the options available with the SRA. Such a change would have the potential to both increase the value to the SRA, law firms and their clients and reduce the cost of required external assurance.

If the SRA is seeking to reduce costs then addressing increasing PII costs should be a priority

11. A stated remit of the SRA is to reduce the cost of legal services to ensure they are affordable and available to the 'man/woman on the street'. If cost reduction is the priority, we are unclear as to why there is no consideration in the consultation of addressing the crippling costs of professional indemnity insurance faced by firms of solicitors. The cost of the accountant's report is likely to be a small fraction of the PII costs that law firms face. We believe that the SRA should focus its efforts on seeking to reduce these costs, which we believe could provide real cost savings to firms and their clients. The current proposals as they stand are more likely to have the opposite effect. At the very least, we believe the SRA should consult with PII providers on the significance they would attach to an accountant's report requirement.

12. We are not convinced that these proposals will reduce the costs to law firms and the SRA that the consultation paper envisages. Responsible law firms will continue to see a need for an external review and will also need to ensure that the Compliance Officer for Finance and Administration (COFA) is appropriately skilled, trained and supported to be in a position to sign a declaration of compliance. Indeed, the absence of any external review would probably be seen as a reflection on the integrity of client fund management and though there may not be an immediate cost impact the future cost of this to the SRA could far outweigh any savings gained.

13. We would therefore urge the SRA to carry out a thorough cost impact assessment taking account of all these issues before implementing these proposals.

Impact on smaller firms

14. If the proposals are adopted, the law firms most likely to take advantage of the relaxation are smaller firms. Yet smaller firms are more likely to be affected by the special circumstances that would instigate a need for a report as they are inherently more risky due to their size and the nature of the work they perform. The likely providers of such a report will be the larger accounting practices as smaller accounting practices are unlikely to maintain the skill base and registered auditor status on the off chance that the SRA will request a report. The cost to a small law firm of having the report prepared by a larger accountancy firm would be significant (see paragraph 34 for more information).

Timescale concerns

15. There is uncertainty around the implementation timetable for the proposals. The SRA needs to clarify the timing of the proposals and any transitional arrangements that will be put in place (see paragraph 35 for more information)

Responsibility for compliance should rest with law firms but are COFAs in a position to provide this comfort?

16. We agree that responsibility rests with firms for ensuring compliance with rules for holding client money but consider that this should be reinforced by requiring the governing body as a whole to confirm compliance. We are concerned that the requirement for the COFA to make an annual declaration is quite a significant change to bring in so soon after the COFA role has been put in place. Consideration should be given as to whether there is sufficient time for them to ensure that they are comfortable with the declaration prior to them being required to make it, as well as a clear means of ensuring that the law firm as a whole signs up to this change. The consultation paper provides no further detail on how this declaration will be done and the extent to which breaches will be reported.

RESPONSES TO SPECIFIC QUESTIONS

Q1: Do you agree with the removal of the mandatory requirement that all firms holding client money must submit an annual accountant's report?

17. Without the SRA addressing the much broader and more fundamental public interest and cost-related issues, we do not believe that seeking to remove the mandatory requirement for an accountant's report because of concerns about cost and effectiveness will achieve the positive outcome sought.

18. We support the principle of proportionate and targeted regulation. We recognised that the current accountant's report is backward looking and considers transactions that have already occurred. The rules have not changed in a material way for many years now and the accountant's report as it stands does not lead to an effective risk-based approach. The current system does not, therefore, provide the SRA with what it believes it needs and neither is it the best use of the skills of our members, though it is the only form of external intervention that law firms have.

19. We acknowledge that the removal of a compulsory report may bring some initial savings to firms who have robust controls and systems in place. It seems likely, however, that many larger and medium-sized firms will continue to have some form of external review and there will continue to be a real need for reporting accountants. While many firms will definitely say "if I don't need to I won't have it", there will be plenty of others open to the possibility of having a more bespoke, risk-focused external assurance service that is more suited to their needs. This should be good for law firms and good for their advisers.

20. We accept that there is an administrative burden on the SRA on processing 9,000 returns and recognise the need to consider alternative options. In this sense the proposal to remove the existing blanket requirement for all firms to have an annual report, along the very prescriptive testing and reporting lines that the existing rules lay down (linked of course to the rules themselves being highly prescriptive) might not in itself seem unreasonable.

21. However, our view is that the Accounts Rules are not fit for purpose; they are inflexible and complex and our members continue to express concerns about their clients' lack of understanding of them. As a result, the current arrangements do not allow a cost effective and risk-based approach to be taken by our members to this work. We believe that the Accounts Rules are therefore in need of a radical overhaul.

22. We strongly believe that there are much broader public interest and cost-related issues in relation to the protection of client money that the SRA should tackle. We would, therefore, urge the SRA to be much bolder in its vision and focus its attention more broadly on how best client interests may be protected, assessing the greatest costs to itself, law firms and their clients and finding ways to mitigate these costs. Having carried out a thorough investigation of the issues the SRA would then be in a better position to set in place regulatory requirements to address these. This includes consideration of what external assurance arrangements might be needed to support this.

23. The SRA's primary focus should be on the protection of client interests and there is a clear public interest argument for supporting robust controls over and regulation of client accounts, particularly considering the significant sums of money that might be involved. These proposed changes could have wide implications for clients and also for new partners joining law firms. They may have concerns that firms are no longer subject to any real on-going external scrutiny on this. Many solicitors tell our members that their clients often ask them how 'safe they are' in terms of receiving client money. They are not referring to which bank they are with but how they are themselves managed financially, given the recent economic crisis and business failures. Many of their clients cite the accountant's report as a third party check and this offers reassurance. The value of the accountant's report to the law firms' clients appears to have been overlooked in the consultation paper.

24. Given the importance of protecting client interests, and without the annual external review provided by the accountant's report, it is unclear from the consultation paper how the SRA intends to address the risk that client funds are mismanaged or misappropriated. Given the frequency, and value, of misappropriation, the SRA should clearly set out the alternative methods proposed to provide comfort to the public that their interests are being protected. Effective regulation includes proactive monitoring by the regulatory body on a routine as well as event triggered basis, as well as a mix of annual declarations and returns from the entities supervised.

25. The changes proposed can be contrasted to recent trends by a number of regulators, including the Financial Conduct Authority, to tighten their client money rules (see paragraph 47 below). As the SRA is going in the opposite direction here, it needs to more clearly explain its plans for monitoring these firms in respect of client money. Paragraph 20 of the consultation paper proposes the deployment of a variety of approaches to mitigating risks, including 'if certain risk circumstances are present' but without any indication of what the risk indicators might be or how they are to be assessed. It would be rash to think that all (or nearly all) problem firms will display clear risk indicators sufficiently early for effective regulatory action to be taken, especially in the absence of any external review and the likely motivation for firms (including their COFAs) to hide the problems.

26. The consultation paper does not consider any alternative external assurance options. It is, for example, possible to gain assurance that is forward looking by asking an external party (possibly the reporting accountant) to review the internal controls surrounding the client money accounts. ICAEW already has guidance in place for reporting on internal controls. Alternatively the SRA could ask for exception reporting (as is currently required by the COFA). Another possible solution to reducing the cost of external assurance would be to require the firm's auditor to perform specific, pre-determined procedures over the firms' compliance with the Rules or to focus on specific risks and to report any issues identified. We would be very happy to discuss alternative approaches with the SRA.

27. The consultation paper acknowledges the deterrent effect that external oversight brings but not strongly enough. The SRA should not underestimate the effect on solicitors of having their client money accounts inspected annually by an independent accountant. It is highly likely that accounting and internal checks would become less rigorous without the expected 'annual external review'. If there is mischief afoot, self-declaration is unlikely to be an effective remedy. The fact that accountant's reports do not result in lots of SRA investigations misses the point.

What they do is ensure there is a process of constructive external advice which, by and large firms follow and keep their systems up-to-date. Without this they are likely to deteriorate slowly over the years, and with more put upon the internal COFA.

28. As cost reduction appears to be a priority for the SRA, it is surprising that there is no overall assessment of the key costs to itself, law firms and their clients in the consultation paper and consideration of how these may be mitigated. The consultation paper also provides no monetised impact assessment or any information about the cost of fraud involving client monies.

29. Our members highlight the soaring costs of professional indemnity insurance (PII) for law firms as a key issue. The cost of having an accountant's report is surely marginal in comparison and people could be mistaken in believing that the SRA has chosen to focus on a quick and easy deregulatory measure at the expense of assessing the more fundamental costs that represent a real burden to law firms. In all likelihood, the proposals as they stand may have the opposite effect to that intended, particularly in relation to PII costs. The SRA should consult with PII providers on the significance they would attach to the accountant's report requirement.

30. The SRA's aim is to reduce the costs to the legal profession, and hence to the consumer but seeking to achieve this by way of removing the requirement for an annual accountant's report, may prove something of a false dawn because

- there is likely to be additional internal time and cost 'auditing' the client account as many firms would believe they will need to do to meet principle 8 if there is no external review;
- responsible law firms will continue to seek assurance so many firms will still opt for some annual external assurance for a combination of reasons; and
- some firms may combine this with more internal review of compliance with the rules.

Either way to imply the costs of regulation will fall is potentially misleading. It will just be spent in a different way.

31. It is undoubtedly the case that there is a cost to external assurance, SRA monitoring and storing such reports. The question is whether the cost is justified (and efficiently spent) in terms of the perceived benefits. Our experience is that stakeholders in the various industries that hold client monies (financial services, real estate, legal, travel, etc.) expect external scrutiny of the organisation's processes over client money and that there is a necessary cost involved.

32. The prescriptiveness of the current procedures adds very significantly to the costs, including for the reporting accountants and their clients as well as the SRA itself. The emphasis in the paper is on the accountant's report when in fact the root cause is the Accounts Rules themselves. By considering a fundamental change to the nature of the annual reporting process, the current requirements could be replaced by more targeted and cost effective regulation and forms of reporting which addressed key risks.

33. As highlighted in paragraph 27, it is highly likely that accounting and internal checks will become less rigorous without the expected annual external review. In the longer term, this could impact the integrity of client fund management, ultimately damage public trust in law firms and increase costs. The SRA should assess how its plans to tackle this risk.

34. There are also additional cost implications for firms at the smaller end of the market. Without having the normal annual workload there will be far fewer accountants with sufficient skill to perform these reviews, which may drive up the costs or reduce quality where firms do get a review. The firms most likely to take advantage of the relaxation are smaller firms yet they are likely be more affected by the special circumstances that instigate a report. Looking at some of the possible criteria in paragraph 20 of the consultation paper they are inherently more risky due to their size, all the SRA's statistics on this have shown that most client money problems

arise in sole practitioner and two to three partner firms and many also undertake the types of work that are deemed higher risk such as probate and conveyancing. As smaller accounting firms are unlikely to maintain the current skill base (and indeed registered auditor status) on the 'off-chance' that the SRA may request a report, the likely providers will therefore be the larger accounting firms. The cost to the firm having the report prepared by a larger accounting firm would be far higher.

35. The timing of these proposals is unclear. The proposals suggest that reports due in October would not have to be submitted but it is unclear whether this means that 30 April year-ends, that are due to be submitted by 31 October, will not need to be submitted or whether this refers to year-ends after 31 October? Some firms may have already instructed reporting accountants for the 30 April 2014 year-end, and these engagements may have already started. Clarification on this point is urgently needed to ensure that firms do not incur additional costs where no longer necessary.

36. Finally, looking at two of the SRA's five principles, identified by the Better Regulation Task Force, proportionality and targeting, there are several questions that can be raised in the context of how well a new regime of 'self-regulation' of client money by firms and self- reporting of breaches is working out in practice so far. Firms in financial difficulty: have COFAs been reporting these? How frequent and how reliable has this reporting proved to be? Law firm client expectations: how are their needs being considered? General economic environment: The SRA has recently carried out a review that showed there is a higher risk of client money being misappropriated in times of recession. Will the circumstances leading to a requested external accountant's report change the next time the economy takes a turn for the worse?

Q2: Do you agree with the proposed amendment to the role of the Compliance Officer for Finance and Administration?

37. The proposal for increased clarity over the whole firm's responsibility for ensuring compliance with Accounts Rules, relayed through the reporting obligations of the COFA, has merit. We have commented before on the importance of firms truly owning the issues of risk management and compliance with the Accounts Rules. This is not a responsibility that can be delegated to accountants or advisers.

38. However, the requirement for the COFA to make an annual declaration is quite a significant change to bring in so soon after the COFA role has been put in place and consideration should be given as to whether there is sufficient time for them to ensure that they are comfortable with the declaration prior to them being required to make it, as well as a clear means of ensuring that the law firm as a whole signs up to this change. We understand from our members that many COFAs are still struggling with the requirements of the Authorisation Rules and may feel ill-equipped to be fully relied upon to sign off on compliance with sufficient authority. As a result many COFAs are likely to have concerns about signing off on this without the comfort of a third party review. Of course, firms could elect to have a review, but there will be some firms who are not prepared to pay for that and some employee COFAs may feel exposed.

39. In our members' experience it is rare to find a solicitor who operates the SRA Accounts Rules correctly. Indeed, the SRA has often given the impression that it is more suspicious of an unqualified report than a qualified one. Often this is because the solicitor does not fully understand the rules and their requirements. It is obvious, therefore, that such a declaration, in the absence of independent testing of the evidence supporting the declaration, will provide a lower level of reassurance to customers and other stakeholders over the firm's compliance with the Rules and protection of client money. History shows that, in difficult economic times, the incentive for fraudulent activities in business increases. Independent assurance is not a complete cure, but it is certainly a strong deterrent. While the economy is emerging from recession, margins in many areas are low and competition between legal practices remains fierce. We believe that the incentives for misuse of client monies are as strong as ever.

40. An external review by a firm of qualified accountants will be a valuable way of ensuring that the rules are complied with and client money is protected but it also ensures that the firm fully understands the requirements of the SRA Accounts Rules. We would be happy to work with the SRA to provide support for COFAs looking for this type of independent review.

41. One of the requirements of OFR was the reporting of 'material breaches' by COFA. The SRA may wish to consider the effectiveness of this self-reporting requirement, against their other interventions with law firms, as this may point toward the likely success of the proposal that the COFA provides annual comfort over the firm's compliance with the Accounts Rules.

42. The responsibility for confirming compliance will rest with a brief statement by the COFA as part of their personal annual PC renewal application. We believe that the SRA should provide further clarification over the form of this annual confirmation. What will the precise wording of the confirmation be? Will it be in line with the current accountant's report form with reference to trivial or other breaches? Will it refer to the basis on which the confirmation is made? Will the COFA be personally liable for statements made in the declaration? Responsibility for compliance with the Rules should not only lie with the COFA but with the whole firm.

43. It is clear that COFAs are likely to need training to ensure that they have the requisite skills, knowledge and experience to deal with these increased responsibilities and to understand concepts such as segregation of duties, internal controls, quality control and assurance, data management and cyber security and take steps to deal with the related risks.

Q3: Do you agree with the proposed changes to the SRA Accounts Rules (attached in Annex 1)?

44. Our responses to questions 1 and 2 above raise fundamental concerns with the proposals in the consultation paper.

45. If, however, the proposals as set out in the consultation paper are to be adopted, the changes to the Accounts Rules to reflect these proposals appear appropriate. We note above that greater clarification of the form of the annual confirmation made by the COFA is needed, including whether this will be in the Accounts Rules or in other guidance.

46. In the event that the SRA requires the delivery of an external accountant's report (under Rule 32), the form of the Accountant's Report Form (AR1) will also require modification.

Q4: Do you have (or are you aware of) any evidence, analysis, or views that will assist us in completing an impact assessment on these proposals?

47. As noted in our answer to question one, our experience is that other regulators as well as non-regulated entities are pushing towards more external assurance rather than less, while regulatory penalties for non-compliance are increasing. Examples in relation to client money include:

- The Financial Conduct Authority (FCA) – increased scrutiny over client money under CASS rules.
- Assurance reports to financial services organisations over client money controls where CASS rules do not apply.
- FCA/Financial Reporting Council (FRC) – new requirement for assurance over controls relating to alternate methods of client money reconciliations.
- Civil Aviation Authority (CAA) – introduction of client money trust accounts and independent accountants' reports.

We would urge the SRA to look closely at what these other regulators are doing and why.

48. Outside the client money arena, new independent assurance requirements are being driven by EU regulations, as well as local regulators such as Ofcom. Even where there are no

mandatory requirements, organisations come to accountants of their own accord seeking independent assurance over their performance data, processes or controls because they want to lead their industry in terms of reputation, match a competitor or take a pre-emptive step to satisfy public scrutiny in light of the threat of further regulation.

49. We note that RICS removed the reporting requirement in respect of client money in late 2006 and that the Law Society of Scotland also removed its requirement for an accountant's report some time ago. We would encourage the SRA to look to their experience of the impact of having done so.

50. We concur with the SRA's acknowledgement that the Accounts Rules need to be critically reviewed. We believe that this review should be undertaken as a matter of urgency and that evidence and guidance should be taken from other regulated sectors where client or customer assets are held. We would be keen to support the SRA in developing improved processes over client money controls and the assurance regime around the issue, which may include:

- more frequent, light touch review and reporting requirements (perhaps quarterly) designed to identify any material issues;
- shorter deadlines for delivery of reports;
- segregation of material from non-material breach reporting requirements, with a separate, accelerated process for reporting any breach that the reporting accountant considers to be material; or
- a 'by exception' system within the regulator's processes that identifies and proactively manages high risk firms, perhaps with a requirement for the reporting accountant to report on identified high risk characteristics.