

SRA BOARD

11 March 2015

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Reporting accountant requirements and Overseas Rules

Purpose

- 1 To seek the Board's agreement to changes to reporting accountant requirements and the Overseas Rules and to the correction of an error in the SRA Handbook Glossary.

Recommendations

- 2 The Board is asked to agree that we should:
 - a) proceed with the proposed approach to amending the Accounts Rules and reporting format to place more emphasis on the professional judgement of the accountant subject to providing detailed drafting points and guidance on key issues (paragraphs 23-25);
 - b) carry out further modelling and assessment before taking a decision as to whether to remove the requirement to obtain an accountant's report from further categories of low risk firms (paragraph 26);
 - c) not require firms to make an annual declaration on the practising certificate return that they have obtained an accounting report and submitted it where qualified (paragraph 27);
 - d) not tighten or enhance existing obligations on reporting accountants to notify us immediately of significant concerns during the course of preparation of their reports (paragraph 28);
 - e) retain the obligation to submit qualified accountant's reports and that this should remain with the firm, rather than with the accountant (paragraph 29);
 - f) announce these decisions of principle now (paragraph 33); and
 - g) defer the formal decision on the formal changes to the Accounts Rules and Overseas Rules, until its meeting in July 2015 (paragraphs 30-32).

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- 3 In relation to Overseas Rules (paragraphs 36 and 37) the Board is asked to agree in principle that we should:
 - a) proceed with moving the accounting provisions for overseas practices into the Overseas Rules - this automatically widens their application (paragraph 38);
 - b) implement a new Overseas Rule 5.1 (a short and revised version of current Accounts Rules 50.3-50.6) subject to detailed drafting to reflect some of the comments made (paragraph 38);
 - c) revise the proposed glossary definition of 'client money overseas' to reflect comments made (paragraph 38);
 - d) reflect further on the overseas accountant's report issue in tandem with the way thinking has moved on in relation to domestic requirements to submit a report, albeit that the different circumstances may well require a different solution (paragraph 38); and
 - e) proceed with these changes to the same timetable as the changes to the domestic Accounts Rules (paragraph 39).
- 4 In order to correct an error in the definition of "out-of-scope money" in the SRA Handbook Glossary 2012, the Board is asked to make the amendment set out in paragraphs 40 and 41.

If you have any questions about this paper please contact Annette Lovell, Director of Regulatory Policy annette.lovell@sra.org.uk or 0121 329 6222

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Reporting accountant requirements and Overseas Rules

Background

Accounts Rules– phase two of changes to reporting accountant requirements

- 5 In July 2014, the Standards Committee and the SRA Board decided to proceed with a phased approach to reforming the reporting accountant requirements in the Accounts Rules 2011 and to engage closely with stakeholders as progress is made¹. The objective is to achieve a more proportionate and targeted approach to the requirement to obtain and deliver an accountant's report, while maintaining an appropriate degree of independent scrutiny.
- 6 The first phase was implemented through rule changes that came into effect on 31 October 2014² which:
 - introduced an exemption from the requirement to obtain an accountant's report for the small number of firms which receive 100% of their client money from Legal Aid Agency work;
 - retained the existing requirement on all other firms to obtain an accountant's report within six months of the end of the accounting period to which the report relates but only required qualified reports to be delivered to the SRA within the same timeframe; and
 - updated the format of the accountant's report to remove unnecessary information fields.
- 7 The phase two consultation to further amend the requirements to obtain and deliver an accountant's report was issued on 18 November 2014 and closed on 28 January 2015.³
- 8 The third and final phase of the reforms will involve a wider review of the Accounts Rules as a whole, with further changes to be implemented in 2016. A

¹ The SRA first consulted on its proposals for changes to the reporting accountant requirements in May 2014. The consultation closed on 19 June. A copy of the consultation paper and a summary of responses can be found here <http://www.sra.org.uk/sra/consultations/reporting-accountant.page>

² SRA Amendments to Regulatory Arrangements (Accountants' Reports) Rules [2014] were made by the SRA Board at its meeting on 17 September 2014

³ <http://www.sra.org.uk/sra/consultations/reporting-accountant-requirements.page>

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detailed timetable for that review has not been set, but we intend to launch a consultation in autumn 2015. In the phase two consultation we invited respondents to suggest any specific areas or issues that they would like us to include in the review.

Summary of proposals in phase two of the consultation on reporting accountant requirements

- 9 The main proposal was to amend the Accounts Rules and the format of the accountant's report to remove the amount of prescribed testing that is required and to place a greater reliance on the professional judgement of the accountant, by asking them to focus on those activities which provide for an effective system for accounting for client money.
- 10 The consultation contained an amended version of the format of the report we are proposing with a draft of how the Accounts Rules could be changed to reflect this new approach. The revisions ask the reporting accountants to carry out work to ascertain whether the firm has maintained an effective client money accounting system which has enabled the firm to substantively comply with the Accounts Rules. Reporting accountants would be required to examine whether the firm has incorporated a number of detailed elements into its client money accounting system.
- 11 We also proposed to introduce risk-based criteria that will exempt firms with a certain profile from the requirement to obtain and deliver an accountant's report. We said that our current thinking was that it would be appropriate to exempt firms which hold an average balance of client funds of less than £10,000 in each accounting year. We also asked to hear about any other categories of firms or types of client funds (such as a suggestion to exclude firms that only receive their own fees into client account) that we should consider excluding from the requirement to obtain and deliver an accountant's report.
- 12 The consultation posed a number of questions around signature and submission of the report which had been put to us in the course of previous consultation and discussions. These were:
 - whether the firm should sign an annual declaration of compliance with the accounts rules;
 - whether the existing obligations on reporting accountants to notify us immediately of significant concerns during the course of preparation of their reports should be tightened or enhanced; and

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- whether we should transfer the obligation to submit the reports to the SRA from the firm (where it currently rests) to the reporting accountant.

13 Finally, we asked respondents for themes or specific issues that we should consider in our forthcoming review of the accounts rules

The consultation responses

14 We received 42 responses to the consultation, including from the Law Society⁴, the Manchester Law Society, the Institute of Chartered Accountants in England and Wales and a number of individual accountancy and SRA authorised firms.

15 There was almost universal welcome of the direction of travel and the proposal to create a greater reliance on the professional opinion of the accountant. There was general agreement that the current regime requires amendment. The concerns of the respondents focused on two main issues.

16 The first was the need for the SRA to provide further guidance on the matters that should be covered in the report. It was felt that without such guidance, uncertainty would lead to inconsistency. It was said that this would also lead to greater costs – there was concern that a more principles based approach might lead to accountants charging more.

17 The second issue related to timing. Many respondents stressed the need to reform the Accounts Rules themselves prior to agreeing any new framework for reporting. Given the SRA's stated intention to reform the Accounts Rules in 2016, there were worries that these measures would lead to extra costs for accountants and firms coming to terms with a new system which would shortly be subject to more radical change.

18 Concerns were also expressed at the intention to implement the new rules for firms with accounting periods ending in April 2015. Larger firms, it was said, would have already conducted interim work with reporting accountants under the old regime. More generally, there would be insufficient time for accountants to get to grips with the new process and this could lead to reporting delays and again increased costs.

⁴ See <http://www.lawsociety.org.uk/policy-campaigns/consultation-responses/reporting-accountant-requirements/>

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- 19 There was again general support for the suggested approach of providing additional categories of lower risk firms that would not have to submit accounting reports. However most respondents stated that they would need to see an analysis of the risks posed by the firms it was proposed to exclude (for example, those with an average client balance of less than £10,000) before commenting in detail. Some respondents also suggested potential other criteria as well as the possibility of requiring reports only every 2-3 years for certain low risk firms.
- 20 Many respondents concurred with our view that it was unnecessary to ask firms to sign a specific declaration of compliance with the Accounts Rules. Those that did not concur felt that this would be a useful way of focusing the minds of those responsible on the issue. There was also a suggestion that the firm's Compliance Officer for Financial Administration (COFA) or one of its managers should co-sign the report with the accountant.
- 21 It was generally felt that the current obligations on reporting accountants to notify the SRA of significant concerns during the course of preparation of their reports were adequate and did not require amendment.
- 22 Although some respondents from the accountancy sector felt that the obligation to submit the report should be transferred to the accountant, the majority of respondents were clear that the duty to submit the report should remain on the solicitor firm.

Conclusions

- 23 We agree that further guidance will be necessary in order to allow an outcomes-based approach to be taken by accountants when assessing compliance with rules that are still written in a prescriptive manner. This will include guidance on what the SRA regards as substantive breaches that should lead to a qualified report, and on issues (such as breaches of the 14 day rule on moving costs from client to office account) that are regarded as more trivial. The guidance could also help clarify the role of the COFA in the process.
- 24 Producing such guidance will help allay fears of the changes leading to increased costs by emphasising key areas for focus.
- 25 There have been helpful suggestions in the consultation responses on areas where further guidance would be useful. We will engage with key respondents (including the Law Society) in producing that guidance.

Recommendation: the Board is asked to agree that we should proceed with the proposed approach to amending the Accounts Rules and reporting format to

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place more emphasis on the professional judgement of the accountant, subject to detailed drafting points and providing guidance on key issues.

- 26 Our current working assumption is that the suggested categories in the consultation paper remain the most likely exclusions from the requirement to obtain and submit an accountants report. These were (a) firms with an average client balance of less than £10,000 over the year and (b) firms that only hold money paid on account of costs and disbursements in client accounts. However, we are carrying out further modelling based on risk indicators and reported regulatory events in order to confirm that these are appropriate 'low risk' parameters.

Recommendation: the Board is asked to agree that we should carry out further modelling and assessment before taking a decision as to whether to remove the requirement to obtain an accountant's report from further categories of low risk firms.

- 27 Our view remains that it is inappropriate to 'regulate by declaration' – firms should comply with all the rules in the Handbook. We do not consider that the alternative suggestion of requiring both the COFA and the accountant to sign the report is to be recommended, as this would lead to problems where the two did not agree on the conclusions in the report.

Recommendation: the Board is asked to agree that we do not require firms to make an annual declaration on the practising certificate return that they have obtained an accounting report and submitted it where qualified.

- 28 There was a clear consensus from respondents that the current requirements relating to obligations on reporting accountants to notify us immediately of significant concerns during the course of preparation of their reports are adequate.

Recommendation: the Board is asked to agree that we do not tighten or enhance existing notification obligations on reporting accountants

- 29 The responsibility to comply with the rules lies with the firm, and those respondents that represented solicitors were particularly clear that we should not change the current requirement.

Recommendation: the Board is asked to agree that we should retain the obligation to submit qualified accountant's reports and that this should remain with the firm, rather than with the accountant.

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- 30 The consultation paper proposed introducing the new requirements from April 2015. However, we now consider that implementation should be moved to version 15 of the Handbook planned for 1 November 2015. We believe that it is important to take on board the concerns expressed by respondents in relation to potential wasted costs for those firms that have commissioned interim audits under the old system, and that we allow sufficient time to engage with stakeholders externally on the production of the further guidance, which may be complex. This will also reduce the risk of any last minute delays in LSB approving the rules.
- 31 This delay will also allow us to complete the risk modelling in order to inform the decision on which categories of firm should be exempt from the requirement to obtain a report.
- 32 We therefore propose to bring the rule changes before the Board for decision at its 15 July 2015 meeting, together with a formal summary and response to the consultation and Impact Statement for publication.

Recommendation: the Board is asked to agree to defer the formal decision on changes to the Accounts Rules and Overseas Rules until its meeting in July 2015.

- 33 However, we propose that an announcement is made now that the SRA has decided in principle to adopt the approach set out in recommendations in paragraphs 19-27 above. This will provide a degree of certainty to firms in advance of November 2015 implementation, and will create the momentum for stakeholders to engage with us on creation of the guidance for publication well in advance of that date.

Recommendation: the Board is asked to agree that these decisions of principle should be announced now.

- 34 Communication of the decision will need to deal with the rationale for changing the reporting requirements before wholesale change of the Accounts Rules themselves. The SRA's reform programme in this area, as in others, involves a staged approach. There are no doubt many issues that will arise in preparation and consultation on a set of new Accounts Rules and any implementation of stage 3 should allow adequate time for these issues to be resolved. What is important is that the changes implemented now in stage 2 are consistent with the general approach that will be taken in stage 3.
- 35 Focusing the accountants report on systems for protecting money, rather than on checklists or minor breaches of technical requirements is an approach that will

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match our intentions in relation to the Accounts Rules as a whole. The removal of categories of lower risk firms from the requirement to obtain a report will free those firms from an unnecessary regulatory burden at an earlier stage than would otherwise have been the case.

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Overseas Rules 2013

- 36 We received 6 responses to the consultation on accounting provisions in the Overseas Rules which was published on 30 September and closed on 22 December 2014.⁵ These responses were made by law firms with overseas offices, by an accountancy firm representing its own views rather than those of its clients, by the Law Society⁶ and the Junior Lawyers Division of the Law Society and by the City of London Law Society on behalf of its members.
- 37 The consultation proposed that:
- (a) the accounting provisions applying to overseas practices should be moved from the main body of the SRA Accounts Rules into the Overseas Rules themselves;
 - (b) the application of the Overseas Accounts Rules should be simplified from the existing application provisions (which currently varies according to the circumstances of the firm/individual and the regulatory requirement in question) but also widened to encompass overseas practices as well as authorised individuals practising overseas. This is in line with the approach taken by the SRA in the adoption of the Overseas Rules as a whole, which was welcomed by international firms;
 - (c) a new Overseas Rule 5.1 should replace the rules in 50.3-50.6 of the SRA Accounts Rules that currently apply to overseas practices. The new rule would cover essentially the same ground as covered at present, but in simpler terms. This new rule would:
 - require the holding of client money (overseas) separate from office money (overseas),
 - set terms of paying in and out of client account (overseas) which offer slightly more flexibility on time scales compared to the domestic rules, reflecting differences in time zones, for example;
 - require exclusive use of funds in client account (overseas) for client' matters and trusts;

⁵ <http://www.sra.org.uk/sra/consultations/overseas-accounts-rules.page>

⁶ See <http://www.lawsociety.org.uk/policy-campaigns/consultation-responses/overseas-accounts-rules/>

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- demand the establishment and maintenance of proper accounting systems and internal controls;
- require the keeping of appropriate accounting records;
- require interest to be paid.

(d) new definitions of client money (overseas) and office money (overseas) should be introduced in order to reduce the uncertainties contained in the current definition of client money (overseas); and

(e) the automatic requirement for accountant's reports to be made on client accounts overseas should be removed and replaced by a requirement for a delivery on request and in a specified form.

The consultation responses

38 The following were the main views expressed in response to this consultation:

(a) There was general agreement that the accounts provisions should be moved into the Overseas Rules. There was one dissenting view amongst the responses received, from one of the 'Big Four' accountancy firms. Their main argument against our proposal was that overseas practices would still need to refer back to the main accounts rules for guidance and that the linkage between the overseas and domestic rules would be weakened. In fact, one strong rationale for moving the Overseas Accounts Rules into the Overseas Rules is to prevent the SRA's domestic accounts rules requirements being exported inadvertently through such linkages, into overseas environments where they may be duplicating local provisions.

(b) There was full agreement from respondents that the current application of the overseas accounts rules was overly complex and caused practices based overseas to fall in and out of the accounts rules, for example when the composition of the management in that office changed between a solicitor and a non-solicitor majority. There were some useful drafting suggestions made by the CLLS in its response which would help to clarify our intention to apply the proposed new rules to the same extent as the wider Overseas Rules, both to individual solicitors practising overseas and to overseas practices.

(c) There were also some useful comments made by respondents on the proposed substance of Overseas Rule 5.1. These comments recommended the inclusion of an additional requirement to return client money where there was no longer any reason to hold these funds and a stronger presumption that interest would be paid on client account.

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(d) There was general disagreement with our proposed new definition of 'client money (overseas)', even if it was acknowledged in the responses that the current definition suffered from a lack of clarity. ("Client money (overseas) - means money received or held for or on behalf of a client or *trust*"). Useful alternative drafting was suggested by the CLLS which would bring the definition of client money (overseas) into closer alignment with the domestic definition.

(e) Some respondents were unhappy with our proposal that the requirement for an annual accountant's report on overseas offices should be removed as a matter of course, on the grounds that this seemed to go against the grain of what was happening in the domestic context. There was recognition, however, from the Law Society in particular, that whilst they might feel unease at the removal of reporting requirements, there was a need to consider proportionality. The CLLS, on the other hand, supported our proposal on the grounds that the situation overseas could be clearly differentiated from domestic circumstances. There are a number of specific arguments that would support the removal of the requirement in an overseas context:

- most of the overseas accountants' reports made at present duplicate local requirements in jurisdictions where the local profession is similar to the English profession (e.g. Hong Kong, Singapore, Scotland etc.) and where there are strict local rules on client money which are designed to achieve the same objective as the SRA's rules but which do so in different ways. The SRA's report does therefore not add to client protection in these cases;
- most firms will not routinely hold client money in many other jurisdictions for reasons including, the fact that they may not be permitted to do so by local codes of conduct, that local banking rules make it very difficult to hold named client accounts or that the practise of law in that jurisdiction does not include the kind of transaction which requires the holding of client money;
- the SRA currently routinely grants waivers to overseas offices that find that they have triggered a reporting requirement under the current rules because the current definition of client money (overseas) is too vague or because the amounts involved are de minimis;
- the SRA is not in a position to review all of the overseas reports that come in and therefore the information being gathered at present is acting more as a comfort blanket than as a trigger for action.
- most financial breaches that have come to light overseas in recent years appear to have come mainly from staff stealing from office accounts and

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these situations have emerged from reports made by the firm's London office;

- a local accountant's report (especially in a small jurisdiction characterised by very close relationships between the professions) will not necessarily be any more rigorous than the scrutiny and control systems imposed by firms themselves. This will be even more true if the Overseas Accounts Rules move into the Overseas Rules where they will sit within a framework that imposes clear obligations on authorised persons and bodies to ensure that they and all those for whom they are responsible (including their overseas offices), 'protect client money and assets'. These rules also require the monitoring and reporting of material and systemic breaches; and
- the cost of producing overseas accountants' reports has been put by one firm at hundreds of thousands of pounds a year. The added benefit of this requirement for clients appears to be negligible and rarely produces any value for the SRA or for the firms themselves.

Recommendations: the Board is asked to agree in principle that we should:

- a) Proceed with moving the accounting provisions for overseas practices into the Overseas Rules - this automatically widens their application.**
- b) Implement a new Overseas Rule 5.1 (a short and revised version of current Accounts Rules 50.3-50.6) subject to detailed drafting to reflect some of the comments made.** The new rule will represent a significant simplification of the accounts provisions for overseas firms, and will provide a useful template when considering any future simplification of the domestic accounts rules.
- c) Revise the proposed glossary definition of 'client money overseas' to reflect comments made.**
- d) Further reflect on the overseas accountant's report issue in tandem with the way thinking has moved on in relation to domestic requirements to submit a report, albeit that the different circumstances may well require a different solution.**

39 We recommend that the changes to the Overseas Rules should proceed to the same timetable as the changes to the domestic Accounts Rules. This will mean announcing a decision in principle now, with the formal rule changes being put to the Board at their July 2015 meeting for November 2015 implementation.

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Recommendation: the Board is asked to agree to proceed with these changes to the same timetable as the changes to the domestic Accounts Rules.

Amendment to the definition of “out-of-scope money”

40 We have identified an error in the definition of “out of scope money” in the Glossary in the SRA Handbook, which occurred when the definition was amended on 31 October 2014. The error has resulted in the term meaning money held by a multi disciplinary practice which relates to those of its activities which are regulated by the SRA or another legal services regulator, as opposed to those which are *not* so regulated. The definition should therefore be amended to read as follows:

“out-of –scope money

means money held or received by an *MDP* in relation to activities that are not *regulated activities*.”

41 This error needs to be corrected as soon as possible and it is therefore proposed that the amendment is made in the next version of the Handbook which is due to be published on 1 April 2015.

Recommendation: In order to correct an error in the definition of “out-of-scope money” in the SRA Handbook Glossary 2012, the Board is asked to make the amendment set out in paragraph 40.

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Supporting information

Links to the Strategic Plan and / or Business Plan

- 42 The proposals are linked to Strategic Objective two: Deliver risk-based outcomes-focused regulation so as to achieve positive outcomes for consumers in the public interest and do so in a way that is justifiable to all our stakeholders.
- 43 The proposed changes to the SRA Accounts Rules and the SRA Overseas Rules to deliver phase two of a programme of reform are integral to our wider objectives to ensure that regulation is proportionate and targeted, with the aim of removing unnecessary burdens, while providing appropriate levels of consumer protection.

How the issues support the principles of better regulation

- 44 The recommendations will make regulation more proportionate and targeted by focusing accounting reports on substantive issues where there are risks to client money and by freeing categories of 'low risk' firm from the requirement to submit a report. The amendments to the SRA Overseas Rules will also meet these principles by removing unnecessary complexity.

What engagement approach has been used to inform the work and what further communication and engagement is needed

- 45 We engaged with stakeholders prior to the consultation and have carefully considered consultation responses. We will engage further with key respondents when producing guidance and refining the categories of firm that will not be required to submit reports –this engagement is likely to be through a working group.

What equality and diversity considerations relate to this issue

- 46 The principal consideration relates to the potential impact on small firms of the proposed changes to the domestic Accounts Rules. Overall, the new format of accounting reports is intended to allow a more proportionate approach. This may benefit small firms in particular. It is important that adequate guidance is provided to mitigate against the risk of accountants' costs increasing because they are uncertain about the changing format. The removal of categories of low risk firm from the requirement to file the report is likely to particularly benefit smaller firms.

Consumer impact

- 47 An approach that focuses more proportionately on the risks to clients' money is likely to benefit consumers. The proposed modelling to inform the proposed

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categories of firm that will no longer be subject to the requirement to obtain the report will help reduce any potential risk to consumers posed by the changes.

- 48 As we acknowledged in the consultation document⁷, there remains a risk that some firms that are still required to obtain an accountants report will no longer do so. We will mitigate this by ensuring the copies of reports are requested when appropriate during engagement with firms (for example when a relevant issue is raised with Supervision or on an FI visit. We will also retain the power to require individual firms to submit reports annually, and have retained the duty on accountants to notify us immediately if they discover theft, dishonesty or any other issue that makes the firm unfit to hold client's money. It is worth noting that concern about this issue did not feature significantly in the responses to this consultation. This contrasts with the responses to the May 2014 consultation.

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⁷ <http://www.sra.org.uk/sra/consultations/reporting-accountant-requirements.page> Paragraph 26