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Newsletter

Accountancy Forum

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Welcome to Reed Smith's accountancy forum newsletter. This newsletter will cover a range of issues affecting accounting firms, with a core focus on liability and regulatory risk. In this edition, we have drafted an article on the recent FRC sanctions and we have also included short summaries of recent cases and items of interest to our target audience. At the end of the newsletter, you will also find links to additional articles that may be of interest. Please do get in touch with any questions and let us know if there's a particular issue/case that you'd like us to cover in an upcoming edition, we would love to hear from you.

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FRC sanctions: Review Panel recommendations

by Jane Howard | *Partner, London Head of professional liability*

The dust is now starting to settle on the keenly awaited Report of the independent Review Panel (the Review Panel) appointed by the Financial Reporting Council (FRC) and chaired by former Court of Appeal judge Sir Christopher Clarke. The Review Panel was charged with conducting a review of the sanctions imposed under the FRC's current enforcement procedures with reference to the Accountancy Scheme (which, going forward, will only apply to non-audit matters), the Audit Enforcement Procedure (AEP – introduced in June 2016 in relation to audits) and the Actuarial Scheme, including as to the fairness and effectiveness of the range of sanctions currently available and, in particular, as to whether the financial penalty sanctions are fit for purpose. The Review Panel considered feedback from a wide range of stakeholders, including investor groups, the FRC, and the Big 4. In so doing, the FRC has come up with 17 recommendations for change and/or clarification of the existing regime. In some areas it concluded that no change was needed, including a recommendation that existing discretionary guidance on how fines are determined be retained. A copy of the full Report can be found here.

Despite last week's headlines prophesying that the Big 4 should expect fines in excess of £10 million from the FRC as a matter of course going forward, a more detailed study of the full Report suggests a rather more nuanced approach has in fact been adopted by the Review Panel. What is clear from what comes across as a well-reasoned and balanced report is that the interests of all stakeholders, including the Big 4, have been evaluated and taken into account (to a greater or lesser extent).

The key conclusions and recommendations are these:

- The reasons for imposing sanctions as articulated in the Sanctions Guidance (under the Accountancy Scheme) and the Sanctions Policy (under the AEP) remain appropriate. They are, however, expressed in the wrong order by putting deterrence before the other three objectives (namely, to uphold proper standards and enhance quality; to maintain and promote public and market confidence; and to protect the public). The order should be reversed, and the objectives should also include the maintenance and enhancement of the quality and reliability of accountancy work and future audits, and the promotion of public confidence in the regulation of the accountancy profession: see **Recommendation 1**.

- The Review Panel concluded that the Sanctions Guidance (under the Accountancy Scheme) and the Sanctions Policy (under the AEP) contain a fair and effective range of sanctions, and strike a balance, as one respondent put it, between "being excessively prescriptive … and unhelpfully vague". The Review Panel recognised (a) that sanctions, particularly fines, have a limited role in promoting good behaviour, and that punishment more generally (whether financial or otherwise) is not an appropriate objective of the regimes audit review; and (b) that fines greater than those which have been imposed to date may be appropriate in really serious cases, i.e., of £10 million or more in cases of "seriously bad incompetence" in respect of an audit of a major public company, where errors are measured in nine figures or more and cause (or risk) widespread losses – they should therefore not apply in every case.

- Rejecting calls for the use of some form of tariff, range or further guidelines as to financial penalties (perhaps based on revenue), the Review Panel concluded that fairness does not require such an approach. The Review Panel observed in this regard that the range of conduct falling within the regulator's remit will, going forward (especially under the AEP), be much more varied now that the bar (at least for audit work) is no longer one of Misconduct but of "breach of a relevant requirement". Sanctions (both financial and non-financial) should be left to the judgment of decision makers in the light of a set of principles and guidance, as is presently the case. It reached this conclusion having regard to the complexities of the many and varied situations with which decision makers will have to deal and the need to do that which is just in each case – which is not a 'scientific exercise'.

- As far as individuals are concerned, although the Review Panel recommended that the Sanctions Guidance and the Sanctions Policy should contain a provision that where an individual has been found to have been dishonest the recommendation should normally be that they be excluded for at least 10 years (**Recommendation 8**), it did point out that the sanction of suspension or expulsion should be reserved for cases of dishonesty, intentional wrongdoing or recklessness. This acknowledges the blight that even the fact of an investigation can have on individuals' careers, and the attendant severe personal stress and anxiety.

- It concluded that greater attention should be given (than has been the case in the past) to the use of non-financial penalties: **Recommendation 7**. This includes a specific requirement to consider whether the sanctions proposed would be likely to lead to improvements in the failings which gave rise to the proceedings and in the quality of work of the individual or firm concerned. Whether the objectives of the Sanctions Guidance and the Sanctions Policy could be achieved without a financial penalty (or with a lesser financial penalty, or the use of non-financial sanctions) should also be considered: **Recommendation 9**.

- A number of recommendations were made in relation to the detailed provisions of the policy and guidance material, namely:

    - The omission of the requirement on decision makers to follow a specific format or order; or, in addition to specifying any financial sanction, to specify a range into which any fine might fall: **Recommendation 2**.

    - The addition to the Sanctions Guidance and the Sanctions Policy of certain additional factors for consideration: Recommendations 3 and These should include the level of cooperation of the Member or Member Firm with the FRC, the impact on the Member or Member Firm of their involvement in the investigation or disciplinary proceedings and the remedial actions taken by either or both.

    - The inclusion of a provision in the Sanctions Guidance and the Sanctions Policy that the existence of a previous sanction on an individual or firm will not automatically be regarded as a significant aggravating factor, and that its significance should depend on a number of considerations: **Recommendation 5**.

    - The amendment of the Sanctions Guidance so as to require decision makers to have due regard to the fact that sanctions have been or may be imposed by another regulator, just as the Sanctions Policy does: **Recommendation 6**.

    - The amendment of the Sanctions Guidance and the Sanctions Policy so as (i) to provide a somewhat greater incentive to timely settlement; (ii) to remove any substantial discount for very late settlement; (iii) to specify that the discount should not be applicable to any part of the proposed penalty which equates to the disgorgement of a profit made or loss avoided or the repayment or waiver of a fee; (iv) to remove the requirement that a full discount should only be available on settlement if the Member or Member Firm (or Statutory Auditor or Statutory Auditor's firm) admits substantially all the heads of complaint in the Formal Complaint or all the findings; and (v) to provide that an appropriate level of discount should be allowed where the Member or Member Firm (or Statutory Auditor or Statutory Auditor's firm) agrees the facts and liability but not the level of financial sanction or discount: **Recommendations 10-14**.

- The Review Panel did **not** recommend certain matters that it was invited to consider, namely that the Sanctions Guidance and the Sanctions Policy should be amended so as to:
    - Provide for a tariff, range or guideline approach.
    - Provide some form of specific guidance as to whether there should be a Reprimand or a Severe Reprimand – this should remain a question for judgment on a case-by-case basis (though the Review Panel did suggest, by way of clarification, that a Reprimand is likely to be appropriate only where the failings are not of any great seriousness and by a first-time offender).
    - Preclude sanction, or any serious sanction, against individuals simply because they were not dishonest or lacking in integrity; or to encourage firmer sanctions against individuals upon whom (as noted above) the process is already inevitably burdensome.
    - Encourage tribunals to require the payment of compensation to those who have suffered loss – this is properly a matter for the civil courts, not for the regulator.
    - Define what is meant by cooperation, although the Review Panel does suggest that the FRC should consider whether further examples could be given in the Sanctions Guidance and the Sanctions Policy as to what "cooperation" may include (the suggestion being that cooperation is expected and that only cooperation "beyond the call of duty" may merit any reduction of the financial penalty).
    - Introduce something like a Part 36 offer procedure in relation to costs, both because the issue was outside of the scope of the review and because the Review Panel rejected the suggestion that the FRC should be placed at risk of costs if it rejected a proposed settlement figure. The Review Panel did, however, suggest reconsideration by the FRC of paragraph 9(9) of the Schemes, which limits the power of the Disciplinary Tribunal to award costs to situations where it dismisses the Formal Complaint in full. The Review Panel observed that this can give rise to real injustice if, for example, 90 per cent but not the whole of the Formal Complaint is dismissed.
- It also recommended that the FRC should make available (in one readily accessible place) on its website decisions of tribunals and other decision makers, including settlement agreements, together with a summary of the cases including details of the respondent(s), the sanctions imposed and a summary of the Misconduct or breach of Relevant Requirement established by the FRC, together with an indication of what went wrong: **Recommendation 15**.
- The Review Panel came out firmly against the idea that decisions made in earlier cases should stand as binding precedents in later ones. It recommended that the Sanctions Guidance and the Sanctions Policy be amended so as to provide that decision makers should determine the sanction which they think appropriate on the facts and circumstances of the case before them and should not feel constrained by the sanctions imposed (or not imposed) in earlier cases to impose a sanction which they do not think appropriate: **Recommendation 16**. In arriving at this conclusion, the Review Panel was mindful of the fact that the number of decided cases are relatively small and that there have, to date, been no decisions at all under the AEP, which only came into force in June 2016.
- Lastly, "but very importantly", the Review Panel recommended that as much as possible should be done by all concerned to accelerate the process of initiation and resolution of disciplinary proceedings, delay having been highlighted as an area of real concern by a number of commentators. It acknowledged that lengthy procedures can inflict real suffering on individuals in particular and (as a matter of practicality) by the time many outcomes are made public there is often nothing left to deter (the defects identified having long since been remedied by the firm itself and/or the wider profession): **Recommendation 17**.

Responding to the findings, the FRC said that it would "carefully consider the report in order to decide which recommendations to adopt and incorporate into revised sanctions guidance". Watch this space.

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Supreme Court finds for accountancy firm following negligent advice

Swynson Ltd and another v Lowick Rose LLP (in liquidation) (formerly Hurst Morrison Thomson LLP) [2017] UKSC 32; [2017] 2 W.L.R. 1161 (SC)

The Supreme Court in *Swynson v Lowick Rose* conducted an analysis of a number of legal principles, including that of 'unjust enrichment', in a professional negligence case. The defendant accountancy firm (formerly Hurst Morrison Thompson LLP) had performed due diligence on a company (E) in advance of a loan, which negligently failed to show a deficiency of working capital. The claimants (S and H) argued that, had they been aware of the deficiency, the loan would not have been made. H made a loan to E, to repay S for payments which were not received from E once issues owing to the deficient working capital had come to the fore. There was no contractual duty between H and the defendant firm, so the claimants argued that the defendant was unjustly enriched.

The Supreme Court held that the purpose of unjust enrichment was not to correct the mistake by H that indirectly benefitted the defendant, particularly as the H's payment was made to E to correct the debt owed to S from E; therefore addressing an entirely separate relationship to which the defendant firm was not party.

Supreme Court finds negligent solicitors not responsible for loss: how this applies across professional services

*BPE Solicitors and another v Hughes-Holland (in substitution for Gabriel) [2017] UKSC 21*On 22 March 2017 the Supreme Court handed down a judgment in a solicitor's negligence case, which has a broad application across the professional services sector. The court discussed a principle from the frequently quoted case of SAAMCO, namely that "a defendant is not necessarily responsible in law for everything that follows from his act, even if it is wrongful".

BPE was instructed to prepare a facility letter and charge on behalf of its client (G) who had made a loan to a company (W), where G had mistakenly believed that the funds would be used for property development. BPE based its letter on a prior template from an earlier (aborted) transaction involving G and a director of W, which contained incorrect statements to the effect that the loan monies would contribute to the development. This accorded with G's misunderstanding.

The court found that no loss was attributable to BPE's negligence, given that it was only instructed to draft the letter. G's decision to lend the money would have taken into account matters for which BPE had no responsibility. In order for a loss to be successfully claimed against a professional, the loss must flow from a breach of responsibility within the scope of the professional's duty.

The Paradise Papers

The recent leaks have once again brought about significant public debate on structures which permit tax avoidance, as well as the professionals who facilitate them. This has in turn put HMRC under further pressure to take a firm stance against improper tax behaviour. While the activity concerned is not technically illegal, the release of this data still raises questions about the fact that the present legal framework permits tax avoidance. In addition, scrutiny has been placed on the roles of lawyers and accountants in bringing about these tax structures, and certain of the Big 4 have been named in the leaked data.

HMRC has been legislating to combat tax evasion, including the creation of the 'Requirement to Correct' and penalties for 'Failure to Correct' in the Finance Bill 2017, and the creation of a new crime of failure to prevent tax evasion under the Criminal Finances Act 2017. The Common Reporting Standards, which come into effect on 30 September 2018, will grant HMRC unprecedented access to information about individuals with offshore interests.

While it is not possible to calculate which of the investments in question have caused a loss of tax to the UK government, HMRC will use data that is available to it and its expanded powers to investigate the situation thoroughly.

KPMG cleared: FRC closes investigation into HBOS audit

After a detailed investigation, the Financial Reporting Council (FRC) announced on 19 September 2017 that it had concluded its investigation into KPMG's 2007 audit of HBOS.

The investigation evaluated (i) whether it was appropriate for KPMG to have accepted the conclusion of the HBOS management that HBOS was a "going concern" as part of its preparation of the 2007 financial statements; and (ii) whether there were material uncertainties as to whether HBOS could continue as a going concern that needed to be disclosed in the financial statements. The FRC found that KPMG's work did not fall significantly short of the standards reasonably to be expected of the audit on the basis that "the evidence of market conditions at that time did not show this decision of HBOS or [KPMG's] assessment of it to be unreasonable at the time. The extreme funding conditions which arose in October 2008 were not anticipated".

FRC closes PwC's Barclays investigation

On 5 October 2017, the FRC announced that it had closed its investigation into PricewaterhouseCoopers (PwC) . PwC was investigated following its role in reporting to the Financial Services Authority (now Financial Conduct Authority) that Barclays had been compliant with the rules on holding client money in relation to its conduct between 2007 and 2011.

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The FRC concluded that there was no real prospect that a tribunal would make an adverse finding against PwC.

Further Reading

https://www.reedsmith.com/en/perspectives/2017/11/eu-data-protection-regulation-are-you-ready-for-the-gdpr

https://www.technologylawdispatch.com/2017/09/data-cyber-security/from-the-server-room-to-the-board-room-do-and-cybersecurity-emerging-trends/

https://www.reedsmith.com/en/perspectives/2017/11/does-your-d-and-o-policy-cover-government-investigations

https://www.reedsmith.com/en/perspectives/2017/10/sec-investor-advisory-committee-considers-blockchain-technology

https://www.reedsmith.com/en/perspectives/2017/11/proposed-legislation-would-expand-cfius-jurisdiction

https://www.reedsmith.com/en/perspectives/2017/09/uk-comp-and-mkts-authority-launches-investigation-into-invst-consultancy

https://www.globalrestructuringwatch.com/2017/08/step-aside-payday-loans-theres-an-old-kid-in-town/

https://www.reedsmith.com/en/perspectives/2017/11/augmented-reality-a-new-legal-frontier-for-marketing

Our Practice

About Reed Smith's Accountants' Liability Practice. From litigation and regulatory defence to reputation management, data security and insurance recovery advice, Reed Smith can help protect your interests. Our lawyers act for 3 of the Big 4 accountancy firms, two-thirds of the top 20 accountancy firms and for more than half of the top 25 international networks of accountancy and business advisory firms.