Regulatory Developments

STATUS

1. The report is open, but the appendices are considered confidential and certain sensitive paragraphs are also redacted.

EXECUTIVE SUMMARY

2. This paper highlights recent news stories and other developments in professional services regulation that may be of interest to the IRB. There is a summary of consultations and consultation feedback in the **Appendix**, however the main body of this report outlines particular items of topical interest.

3. This document discusses the following in more detail:

a) New FRC CEO appointed
b) Delays to audit reform
c) FRC consulting on Ethical Standard
d) Local audit accounts to be published
e) Audit quality improvements at large firms
f) Audit firms to justify de-risking
g) FRC Annual Enforcement Review
h) FRC Thematic Review of Climate Disclosures
i) Record number of stewardship code signatories
j) LSB's review of enforcement tools
k) CILEX to transfer regulation to SRA
l) LSB consulting on technology & innovation

RECOMMENDATIONS

4. The IRB is asked to consider whether any of these developments could be of relevance to ICAEW's own regulatory activities and whether it wishes PSD senior management to follow up any of the developments noted here. The appendix is for note, but the board may ask questions of staff where further information is required.
5. The IRB is asked to approve the classification of the paper as open and identify where redaction may be appropriate, as has been highlighted in green. Also agree to the non-disclosure of the appendices.

NEW FRC CEO APPOINTED

Richard Moriarty announced as new CEO of Financial Reporting Council

https://www.gov.uk/government/news/richard-moriarty-announced-as-new-ceo-of-financial-reporting-council

6. Richard Moriarty has been announced as the CEO of the Financial Reporting Council (FRC). He replaces Sir Jon Thompson, who has led the FRC since 2019. The FRC comments that Richard will continue the work started by Sir Jon to transform the FRC into a new regulator – the Audit, Reporting and Governance Authority.

7. Richard has at least two prior connections with ICAEW/PSD. He was the CEO of the LSB at the time when discussions first took place in 2013 about ICAEW applying to be authorised for probate and encouraged ICAEW's application. Richard was also the CEO of the Civil Aviation Authority at the time when the CAA approached ICAEW (PSD) to see if ICAEW would support the setting up of a scheme to give additional assurance to the CAA about the audits of ATOL agents. This led to the creation by QAD of the Licensed Practitioner Scheme which has run smoothly now for 6-7 years.

DELAYS TO AUDIT REFORM

UK government set to omit audit reform from legislative plans

8. The Financial Times reported on 1 September 2023 that the UK government is preparing to omit audit reform from its programme of flagship legislative reforms for the coming year. The expected omission of these reforms in November's King's Speech would mean that they are unlikely to happen before the next general election.

9. The main proposal of the audit reform package is to replace the Financial Reporting Council with the Audit, Reporting and Governance Authority. The changes would also classify about 600 additional private companies as "public interest entities", resulting in tighter regulation.

10. The article comments that senior figures at the FRC have expressed frustration about the likelihood of further delays with the reforms. The FRC was now planning on the basis that ARGA may not be up and running until 2026 or 2027. The FRC has doubled in size to almost 450 staff in the past four years

11. When asked about the impact of repeated delays in introducing the reform legislation, acting FRC chief executive Sarah Rapson told the Financial Times: "There are areas where we are not able to make progress." She said that without the legislation, the regulator was unable to take on a bigger role in policing directors of companies or introduce measures to increase competition for the Big Four accounting firms — Deloitte, EY, KPMG and PwC — by making them share audit work with smaller rivals.

FRC CONSULT ON ETHICAL STANDARD

FRC consults on revisions to Ethical Standard for auditors

12. The FRC has issued a consultation on revisions to the FRC's Ethical Standard to further enhance and clarify the principles of integrity, objectivity and independence auditors must abide by.

13. In the FRC's 2022 position paper on audit market reform, the FRC committed to revising the Ethical Standard, and to consult at the same time about the withdrawal of the Other Entities of Public Interest (OEPI) category introduced in 2019. This is in light of the government's proposed changes to the statutory Public Interest Entity (PIE) definition.

[redacted] The proposed revisions to the Ethical Standard enhance prohibitions where an audit firm's independence could be threatened by an economic over reliance on fees from specific entities that are connected. Other changes to prohibitions reflect relevant findings from audit inspections and enforcement cases [redacted]

15. Additional changes reflect significant developments in the International Ethics Standards Board for Accountants (IESBA) Code since the FRC last revised the Ethical Standard in 2019. These ensure that the UK's Ethical Standard is no less stringent than the international code.

16. The new standard has also been revised to ensure breaches of ethical standards are reported to the FRC on a more timely basis.

17. ICAEW's Reputation and Influence department will be leading the response to the consultation, although Regulatory Policy have been invited to join the steering group overseeing the response.

LOCAL AUDIT ACCOUNTS TO BE PUBLISHED

Ministers to force local councils in England to publish long overdue accounts

18. Following long-running concerns over the backlog in the local audit market, it has been announced that government will force hundreds of local government bodies in England to publish overdue accounts within months. Under these plans, public bodies would be required to finalise more than 500 sets of overdue accounts by September 2024, even if external auditors are unable to give them a clean bill of health.

19. As part of the plans, the FRC would not conduct inspections of auditors' work on the accounts for the years up to and including 2021-22. In a report in June, the House of Commons public accounts committee called on the government to "urgently" get a grip on

the financial oversight of public bodies in England. It found that just 12 per cent of audits were completed on time last year, adding to a backlog of hundreds dating back to 2015-16.

20. Local government minister Lee Rowley wrote in a letter setting out the plans last month that the delays were “clearly unacceptable”, adding that the intervention was “necessary to reset the system and to restore the assurance which is provided by timely annual audits”. But he also warned that the tight new deadlines “may result in qualifications and disclaimers of opinion in the short term for a number of local bodies”.

21. Acting FRC chief executive Sarah Rapson told the Financial Times the steps were necessary and that the regulator would adjust its approach accordingly. She described it as a “one-off solution” and said the FRC would not show similar leniency elsewhere. The FRC said it would still review historical audits where there was “a clear and irrefutable case to do so” and could still take enforcement action against auditors in cases where there were “significant financial and governance failures”. Rapson said the intervention would “buy us some time” to devise longer-term solutions but added the regulator would need greater powers to oversee the local government audit system.

22. The FRC has not yet published details of the deadlines for filing overdue accounts. The FRC said it expected accounts for years up to 2019-20 would need to be filed by the end of this year. Financial statements for 2020-21 and 2021-22 would be due by the end of March 2024, and overdue accounts for 2022-23 would need to be filed by September 2024. These deadlines would be subject to parliamentary approval.

AUDIT QUALITY IMPROVEMENTS AT TIER 1 FIRMS

FRC Inspections show improvements at the largest firms

23. The FRC has published its annual inspection and supervision results of the largest audit firms (BDO, Deloitte, EY, Grant Thornton, KPMG, Mazars and PwC). Overall, 77% of audits inspected were deemed good or required limited improvement. This percentage reflects a year-on-year improvement spanning four years, with a 10% increase compared to the 67% recorded in 2020.

24. Five of the largest firms had no audits requiring significant improvements and the overall number of such audits has reduced from 7% in 2021/22 to 3% of audits inspected this year.

25. The FRC comments that it is encouraging to see Mazars and BDO both showing signs of improvement following initiatives and actions put in place to raise their audit quality. BDO’s audit inspections revealed that 69% of audits were considered good or requiring only limited improvement, a notable increase from the previous year’s 58%. Similarly, Mazars saw an improvement, with 56% of their audits meeting the desired standards, up from 50% previously. However, the FRC is disappointed with the overall results and lack of progress in some areas. There remains work to be done as they continue to fall below the standard of their peers.

26. The report also highlights how management and audit committees play an integral role in the audit ecosystem and sets out examples of steps that audit committees can take to drive responsive and high-quality audits.

AUDIT FIRMS TO JUSTIFY DERISKING

UK regulator tells auditors to justify ditching risky clients

27. The FRC has told auditors that they may have to justify disengaging from clients they perceive as too risky. The FRC's view is that its new audit firm governance code, which came into effect in January, states that auditors must take account of the public interest when they take on or decline work.

28. Resigning from auditing a challenging company due to its weaknesses of management, a breakdown in relations, or where the company refuses to pay a fair price, would not necessarily be seen as an acceptable "de-risking" strategy, the FRC said.

29. "Firms must ... have sought to address and resolve concerns through all available mechanisms prior to resigning," it added.

FRC ANNUAL ENFORCEMENT REVIEW

FRC resolves record number of enforcement cases

30. The FRC has published its latest Annual Enforcement Review which reveals that a record number of cases were resolved in the year 2022/23, with financial sanctions of £40.5m imposed. The year saw the FRC's highest ever sanction of £20 million (imposed by the Independent Tribunal) in a case which the FRC says underscores the seriousness of providing deliberately misleading information to the FRC's inspections team.

31. The FRC comments that its ongoing commitment to timely enforcement action is reflected in year-on-year improvements in the published KPI over the last five years with 75% of cases meeting the KPI in 2022/23. This reflects the maturity of changes implemented over the period including growth in the Enforcement Division's headcount and methods of honing case focus such as the introduction of in Division specialist senior audit expertise.

32. The report highlights and welcomes the growing commitment to self-improvement and cooperation demonstrated by subjects of Enforcement investigations this year which is essential to embedding quality improvements and has resulted in discounts in headline financial sanctions ranging from 25-43%.

Accountancy regulator says 25% of inquiries 'too slow'

33. Commentary in the business press was less positive however, with The Times saying that the FRC has admitted that a quarter of cases are still taking longer than it would like. The Financial Reporting Council closed 19 inquiries between June 2022 and May 2023, 12 of which resulted in sanctions for offending auditors.

34. The Times comments that the FRC has a target of completing its cases within two years and last year it achieved that in three quarters of its inquiries, its best performance. However, it still means that a quarter of its investigations are dragging on for more than two years, much to the ire of those working in the industry.

[redacted]

FRC THEMATIC REVIEW ON CLIMATE DISCLOSURES

FRC thematic review examines quality of climate-related metrics and targets disclosures

36. The FRC has published a thematic review, assessing the quality and maturity of climate-related metrics and targets disclosures. The review analysed TCFD disclosures from 20 companies' 2022 annual reports across four sectors: materials and buildings, energy, banks, and asset managers. It identified areas of better reporting practice as well as opportunities for improvement.

37. Key findings show an incremental improvement in the quality of companies' disclosure of net zero commitments and interim emissions targets. However, disclosures of concrete actions and milestones to meet targets were sometimes unclear, and comparability of metrics between companies remains challenging. Given the large volume of information presented, many companies are finding it challenging to explain their plans for transitioning to a low-carbon economy clearly and concisely.

38. The review also found that explanations of how climate targets affect financial statements still need improvement. Boilerplate language on climate being 'considered' provides little insight on impacts.

39. FRC Executive Director of Regulatory Standards Mark Babington said:

“This review highlights the continued need for clearer, more decision-useful disclosures of companies’ plans to transition to a low-carbon economy. We encourage companies to focus on explaining targets, actions, and any impacts on the financial statements.

“With greater maturity in reporting, we expect clearer and more concise disclosures reflecting how companies measure and manage their individual climate risks and opportunities.”

SIGNATORIES TO CORPORATE GOVERNANCE CODE

FRC welcomes record number of Stewardship Code signatories

40. The FRC has announced a record number of successful signatories to the UK Stewardship Code following the latest round of applications. There are now 277 signatories to the Code, representing £44.6 trillion assets under management. This includes 189 asset managers, 69 asset owners and 19 service providers. 27 organisations have been added to the signatory list, and 164 organisations successfully renewed their signatory status following the Spring 2023 application window.

41. The FRC comments that the strength of the principles-based and flexible nature of the Code is evidenced by growth of the signatory list to date, which includes a wide range of organisations by size, asset class and strategy. The FRC is pleased to see continued growth in the assets other than listed equity covered by the Code, and continued progress in the reporting of stewardship activities and outcomes by signatories, for example, in improving the board diversity at investee companies and improved disclosure related to climate change and biodiversity.

LSB REVIEW OF ENFORCEMENT TOOLS

Legal Services Board to review regulators' enforcement tools, including financial penalties, to ensure they are sufficient to tackle wilful and serious misconduct - The Legal Services Board

1. The Legal Services Board (LSB) has announced plans to review the enforcement and investigative tools available to the legal services regulators, including the Solicitors Regulation Authority (SRA). This could include increasing financial penalties available to regulators, as well as enabling regulators to proactively gather information and share intelligence to help them detect and address misconduct. This is in response to the LSB's long-held view that existing penalties may be insufficient to deter wilful and serious misconduct in some areas.

2. The LSB already has work underway to review regulators' disciplinary and enforcement processes, following weaknesses identified through its annual regulatory performance assessments. The LSB will assess the progress made by regulators in addressing these weaknesses as it considers the case for strengthening the enforcement tools available to them.

3. Under section 69 of the Legal Services Act, the LSB has the power to recommend to the Lord Chancellor changes to the functions of legal services regulators, including in relation to the level of financial penalty that can be applied when misconduct has been identified and established. The LSB's review is being carried out with a view to framing, subject to statutory process and consultation, an appropriate recommendation.

4. Alan Kershaw, Chair of the Legal Services Board, said:

'The public rightly expects that lawyers in England and Wales will uphold the highest professional standards and ethical conduct.

‘For some time, we have been concerned that a lack of effective fining powers among some regulators, particularly the Solicitors Regulation Authority, may hamper their ability to tackle wilful and serious misconduct. We are anxious to ensure that regulators have the most effective tools available to identify and deal with such misconduct.

‘At the same time, the LSB needs to have confidence that first class enforcement powers are accompanied by first class enforcement processes that are fair, transparent and timely.

‘We will address these issues to help build public trust and confidence in legal services – an objective we hope everyone will get behind.’

SDT To Oppose SRA Getting Unlimited Fining Powers

5. In a related article, the Solicitors Disciplinary Tribunal said that it will challenge a proposal to give the Solicitors Regulation Authority unlimited fining powers, amid possible changes to the regulator's tools to tackle serious misconduct in the profession.

CILEX TO MOVE REGULATION TO SRA

CILEX Presses Ahead With Plan To Switch Regulator

6. The Chartered Institute of Legal Executives has said it is pressing ahead with transferring the oversight of approximately 17,000 of its members to the solicitors' watchdog after a public battle with its current regulator over the plan.

SRA consults on arrangements for regulating CILEX members

7. In a parallel consultation, the SRA is seeking views on proposed changes to its regulatory arrangements to enable it to regulate CILEX members in the event that CILEX decides to proceed with redelegation.

8. This consultation summarises the model the SRA has proposed to CILEX for the future regulation of its members. It invites views on the key changes the SRA would make to its Standards and Regulations and processes to bring authorised CILEX members (primarily Chartered Legal Executives and CILEX Practitioners) within the scope of SRA regulation as ‘authorised CILEX lawyers’. These include:

- A Code of Conduct for individual authorised CILEX lawyers. This is intended to deliver high professional standards and to maintain a clear separate identity for authorised CILEX lawyers as regulated legal professionals.
- Education and authorisation rules setting out how authorised CILEX lawyers will be authorised to provide reserved legal services and immigration services on the basis of their specific expertise. These are largely based on the current CILEX and CRL rules and will maintain a clear separate career path for CILEX members.

9. The SRA also sets out how it will approach investigation and enforcement where there is a report that an authorised CILEX lawyer has breached the SRA’s regulatory requirements.

10. After the consultation closes, the SRA Board will consider the responses and decide on the way forward in the context of the outcome of the CILEX consultation. The SRA says it would therefore not expect to be in a position to take on the new functions until summer 2024 at the earliest.

LSB CONSULTATION ON TECHNOLOGY & INNOVATION

LSB consults on tech and innovation guidance to improve access to legal services - The Legal Services Board

11. The LSB has launched a consultation on its draft statutory guidance on promoting technology and innovation to improve access to legal services.

12. LSB research estimates that 3.6 million individuals have an unmet legal need in England and Wales annually. Increased adoption of technology and innovative services could help to address this. Most members of the public are willing to use a variety of technologies to access legal services and are open to service innovations such as unbundling. Qualitative research for LawtechUK and the LSB found that more than 75% of small businesses say they would be interested in using lawtech solutions for their business needs.

13. In England and Wales, six in ten (60%) law firms agree that their clients expect them to use technology to deliver legal services, and nearly half (49%) agree that technology can make it cheaper to provide legal services.

14. The LSB comments that regulation should be focused on unlocking the benefits of technology and innovation to improve access to legal services by people and businesses who need them . The regulators also have an important role in proactively identifying and mitigating risks to protect consumers, particularly as technologies like artificial intelligence continue to be developed and applied more widely.

15. The LSB's draft statutory guidance for legal services regulators aims to promote:

- greater access for consumers to a broader range of legal services that better meet their diverse needs;
- a legal services market that is open to technology providers and legal services innovators who wish to enter the market and deliver services to consumers; and
- improved access to justice and a reduction in unmet legal need.

If the guidance is introduced, the LSB will consider how regulators take account of it through its annual regulatory performance assessment.

16. Matthew Hill, CEO of the LSB, said:

'Technology and innovation could dramatically enhance access to legal services for the millions of people and small businesses who need them. The Covid-19 pandemic has already seen an increase in law firms implementing new technologies like video conferencing, and every day sees new applications for technologies like AI. While it will, of course, be important for regulators to understand and respond proportionately to risk, they will need, first and foremost, to adopt an open stance on technology and innovation if we want the public to benefit from the improved access to legal services they can bring.

‘We look forward to hearing from a wide range of stakeholders through this consultation and working with the sector to ensure technology and innovation support the delivery of legal services that better meet society’s needs.’

17. The consultation will run for 12 weeks from 10 July 2023 to 5.00pm on 2 October 2023.

[redacted]

Two-thirds of large law firms researching generative AI

19. In a related article, a report has found that nearly two-thirds (64%) of large law firms in the UK are exploring the potential of generative artificial intelligence (AI), along with around a third of smaller firms. However, researchers said 90% of almost 1,200 lawyers and legal support workers involved in the study said they were concerned about the technology’s ethical implications. Half of in-house counsel expected their law firms either to be using it already or introducing it within the next 12 months.

20. LexisNexis polled 1,175 lawyers and legal support workers in May and June this year for the report *Generative AI and the future of the legal profession*. They were based at law firms, in-house legal departments, barristers’ chambers, in the public sector and at charities. Almost all of them (95%) believed generative AI like ChatGPT would have an impact on the practice of law, with 38% describing it as “significant” and 11% “transformative”. Two-thirds admitted to having “mixed” feelings as to whether this impact would be positive or negative. 90% said they had had concerns about the ethical implications of generative AI.

21. Two-thirds of legal professionals believed that generative AI would increase the efficiency of legal work. The technology was seen as having the most potential for researching matters (66%), followed by drafting documents (59%), document analysis (47%), and then writing emails and conducting due diligence, both on 32%.

Susskind: AI could crack the problem of unmet legal need

22. A legal futurologist, Professor Richard Susskind, has said that Artificial intelligence (AI) will open up the world of legal services to a new generation of consumers by helping them work out how lawyers can assist with their problems. The breakthrough would come through “systems that systematically ask their users questions – to help pin down and actually categorise and classify the problems or issues on which they want guidance”.

23. According to the legal press, the difficulty with clients identifying the nature of their legal problems has dogged the growth of the sector and led to repeated findings of significant unmet legal need which has stifled demand.

24. Professor Susskind's suggestion is that lawyers and others should ask themselves how generative AI would affect access to justice and clients generally. "In law, the most exciting possibilities lie not in swapping machines and lawyers but in using AI to deliver client outcomes in entirely new ways – for example, through online dispute resolution rather than physical courts and, more fundamentally, through dispute avoidance rather than dispute resolution."

APPENDICES

	Appendix Name	For consideration or for reference	No of pages
Appendix A	**Review of consultations and feedback September**	**Reference**	**3**
Appendix B	**Review of consultations and feedback July and prior**	**Reference**	**4**

Author	Sophie Wales, Head of Regulatory Affairs and Policy
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