Risk profile of the profession 2021.

While accountancy businesses have adapted well to remote working, and appear to have been less adversely impacted by the Covid-19 pandemic than many other sectors, we anticipate an increased claims risk for the profession in 2021 and beyond.

Triggers include:

> Business disruption and regulatory changes resulting from Brexit

> Increased economic uncertainty and business failure resulting from Covid-19 and lockdowns

> Increased regulatory oversight

> A dramatic increase in sophisticated cyber attacks

Accountancy practices of all sizes are advised to review their risk controls to ensure that they best address the claims risks relevant to their work types.

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Made possible QBE

The Accountancy Market 2021

Many accountants have been busier than normal during 2020[1] and in the initial weeks of 2021. According to an Accountingweb[2] survey conducted in late 2020, there has been significant call on accountants' time providing advice and support on furlough claims, loan and grant applications, and wider government support initiatives. Restructuring and insolvency work has inevitably seen an uptick also, which is likely to continue into the foreseeable future.

This is not to suggest that 2020 and 2021 have been an easy trading environment for accountancy practices. As for all businesses, and individuals, Covid-19 and associated lockdowns have made for a much more complex trading and working environment, as have Brexit and a tightening regulatory context.

Looking at the impact of Covid-19 alone, the same Accountingweb survey found (a reassuringly low, but still significant), 20.9% of firms reporting a negative effect on the level of client service caused by lockdown and remote working, and 34.8% reporting a decline in productivity.

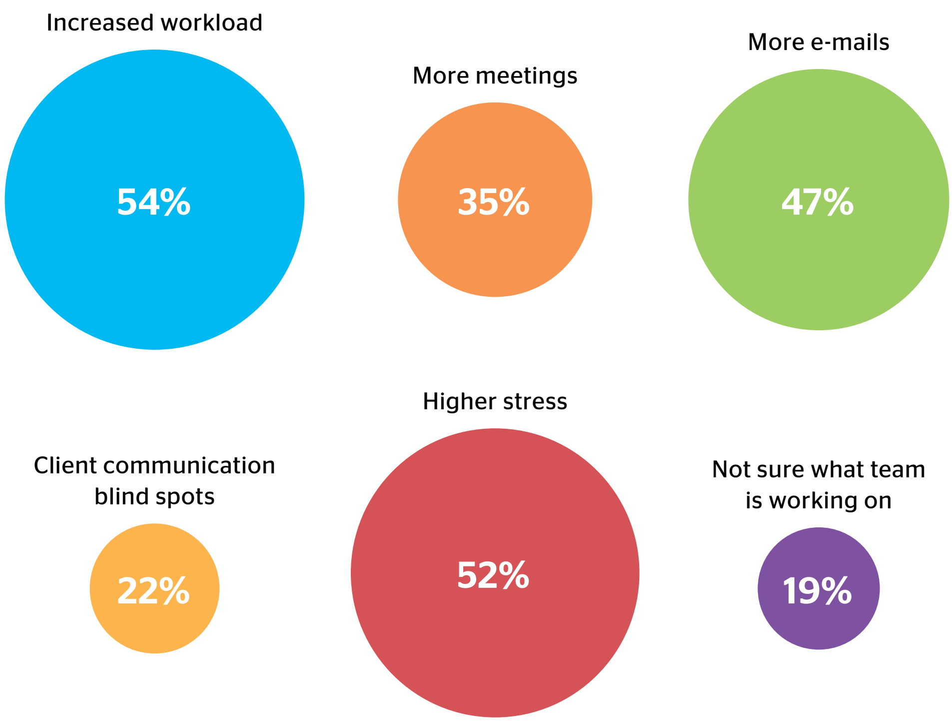
Illustrating some of the negatives of additional work and ongoing remote working, Karbon Magazine's survey in summer 2020 identified 52% of respondents experiencing higher stress, 22% concerned about client communication 'blind spots' and 19% not sure what their team was working on.

The dramatic recession triggered by the pandemic and subsequent lockdowns of the economy has not only made working conditions for many more complex, but has inevitably created an unstable environment for most businesses and therefore a much riskier one for professional advisers, including accountants. QBE anticipates more claims to be made against accountants in the coming months and years, in consequence.

With reference to recent claims data and some specific claims 'case-studies' we highlight likely claims risks for accountancy professionals and suggest some strategies to reduce exposure to such claims.

[1] A survey by Karbon Magazine of 737 Accountancy businesses in 20 countries in June 2020 found 70% of respondents' reporting being busier. https://karbonhq.com/resources/accounting-firms-adapt-to-covid-19-challenges/

[2] https://www.accountingweb.co.uk/community/industry-insights/industry-survey-pandemic-impact-on-accountants

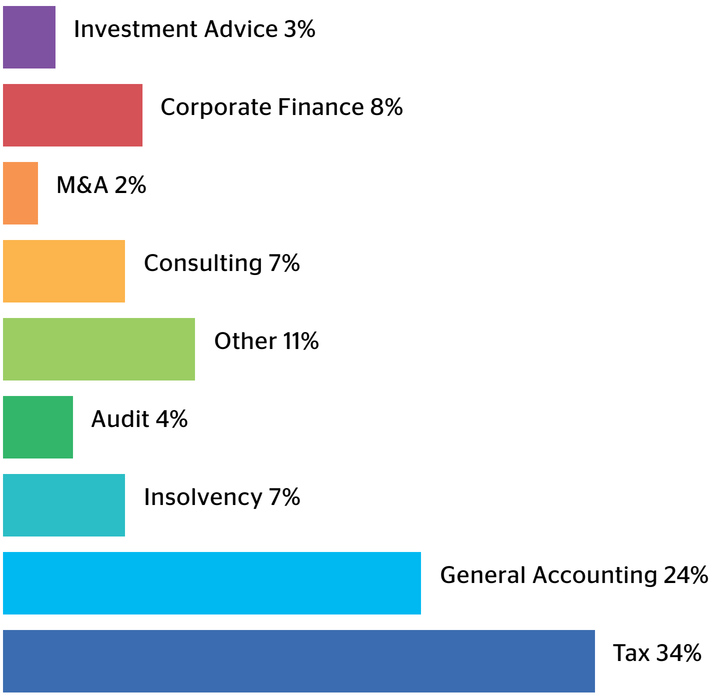


Historic claims

The claims made against accountants in the past five years largely fall into three core areas of practice: audit, insolvency, and tax. Errors and failures to advise on tax affect all practice sizes, but account for a far greater proportion of smaller firms' claims, both by number and value, than they do for larger firms, where audit claims typically dominate in number and value by a significant margin.

Claims against smaller accountancy practices

Profile of claims by number



Analysis of claims against smaller accountancy firms shows that 34% of claims over a 5-year period relate to incorrect or a failure to provide tax advice. Such claims also account for 36% of claims by value.

In this sector, the second largest cause of claim by a significant margin is general accountancy work such as the management, preparation and submission of clients' accounts, representing a further 24% of claims (27% by value).

There has been an increase in claims against many smaller accounting firms arising out of the Coronavirus Job Retention Scheme (i.e. the Furlough Scheme) and the Self Employed Income Support Scheme (SEISS). The value of these claims is usually quite low. The claims arise because small companies (or a small number of employees) were not registered (as they ought to have been) online with HMRC by the Furlough Scheme cut-off dates. As a result of non-registration those companies were not eligible to claim furlough payments from HMRC and have made claims against their accountants for falling to register the company online with HMRC.

Claims against larger accountancy practices

There is a single stand out cause of claims against the largest accountancy practices: audit of public companies. Audit claims also account for the largest claims payments by a significant margin, with total claims incurred figures QBE has seen typically ranging from £2,000,000 to £30,000,000, with some higher still. Many claims have resulted from high profile business collapses notwithstanding audit reports - which have not identified the underlying issues.

Case study: Company audits & source of funds

An off-shore investment fund promising high returns had effectively 'sub-contracted' its management of assets to an unregulated entity, by provision of a loan to another off-shore registered company ('the company') for the purposes of investment. The investments made by the company with the loan monies from the fund were entirely at odds with the stated investment criteria of the fund and formed part of a fraudulent scheme.

A claim was made against the company's auditors by insolvency practitioners appointed when the loan was called in but was not repaid following discovery of the investment fraud.

While the auditors were able to argue that, as auditors of the company, they did not have a duty of care to the fund, and also, in the particular circumstances, that the fund had not relied on their audit as a condition of making the loan, they were not able to escape liability for a failure to investigate the source of the company's assets and where they had been invested.

Risk management learning points

> **Risk-assess clients and instructions** – complex and opaque off-shore entities are inherently higher risk

> **Undertake robust due diligence on prospective audit clients** – including enhanced due diligence on higher risk clients where appropriate

> **Have a clear policy on what types of work are within your risk appetite.**

For mid-tier practices, tax advice claims are the most common cause of claims, with such claims frequently reaching low seven figure incurred sums.

Case study: Advising on tax

A firm of accountants advised the controlling shareholders of an IT company that the company's share structure was such that the proceeds of any sale of shares would qualify for Entrepreneur's Relief ("ER") – meaning that any capital gain would be taxed at 10% rather than the usual 20%. The company subsequently developed a very successful app and grew significantly, undergoing a share restructure.

When the controlling shareholders thereafter sold their shares, realising a significant capital gain, HMRC rejected their ER claim on the grounds that the company share structure no longer met the strict rules required for ER. Had the restructure been undertaken slightly different, it was alleged that the ER claim would have been valid. A successful claim was made against the accountancy firm.

Risk management learning points

> **Be alert to potential tax implications, including in discrete 'stand-alone' pieces of work, and revisit previous tax advice when advising a client on subsequent matters.** Incremental changes to a business or an individual's circumstances, and changes to tax law and thresholds may materially impact the tax situation

> **If tax advice is not part of an instruction, ensure it is clearly excluded in your terms of business, and that this is brought to the attention of your client.** Be aware that this does not necessarily exempt you from advising that there may be tax implications which they should seek advice on as an additional service

> **Always check the latest tax rules and HMRC guidance before advising on tax relief matters and ensure that such guidance is cascaded to all fee earners,** and reflected, where appropriate in template documents.

Future claims trends

Year end accounts claims

The last year has seen a large amount of economic uncertainty, exacerbated by a constantly changing set of restrictions placed on businesses, an off-on-off economy, radical changes in 'the high street' and Brexit. This uncertainty has many impacts, including on business asset valuations: commercial property values may well fall due to a lack of demand in both office and retail space; non-financial assets such as goodwill may be impacted by the inability to trade, or a decline in demand or prices. It will therefore be difficult for accountants to prepare accurate accounts and where mistakes are made, there is a claims risk exposure.

Claims against insolvency practitioners (and by them)

Notwithstanding signs that the economic fall-out from Covid-19 during 2021 may be less severe than previously anticipated, the number of corporate insolvencies will continue to rise, leading to an increase of workload for this sector. Administrators are also at risk from claims for the way they handle the administration. Requests for information under sections 234 - 236 of the Insolvency Act should be taken as a warning sign. Claims against Insolvency Practitioners often involve allegations that assets have been sold at an undervalue. Claims of conspiracy (alleging collusion between Insolvency Practitioners and a company's creditors) are more common in this area.

The Corporate Insolvency and Governance Act 2020 was rushed through in the wake of COVID-19. The Act creates a new moratorium process. This is a director-led process which leaves the directors in-situ to trade the company with a "monitor", usually an insolvency practitioner, overseeing the company's affairs. Monitors may be a new source of potential claims. For example, the moratorium (which in summary is a 20-day break, providing protection from certain creditor action) can only continue if the monitor remains satisfied that a rescue of the company is possible.

Where a monitor decides a company can't be rescued and ends the moratorium early, there is clearly potential for complaints and claims.

The duties and responsibilities of the monitor are somewhat fluid at present and are likely to change. Insolvency practitioners acting as monitors will therefore be subject to a certain degree of uncertainty.

Times of economic hardship inevitably lead to more insolvencies. As part of their role Insolvency Practitioners are required to call in as many of the company's assets as possible – this will include investigating possible legal claims which inevitably shines a spotlight on the failed company's accountants and auditors. Claims are also often made against the company directors – the directors often try to divert those claims to the company accountants (especially in the case of owner operated businesses). The ATE and Litigation funding markets are also actively involved in funding claims by Insolvency Practitioners.

Case study: Undervalue claims in insolvency

A firm of Insolvency Practitioners was appointed as the administrator, and then liquidator, of a restaurant chain. The chain had had cash flow problems, and a falling out between the two 50% shareholders meant that one of the shareholders was unwilling to invest further capital in the business and the company was effectively 'deadlocked'. Only one of the shareholders was a director and they put the company into administration without informing the other shareholder. The assets were sold to a competitor, who had previously made offers to buy the business.

The disgruntled shareholder bought proceedings against the other shareholder, the business's accountant and the Insolvency Practitioner alleging that the assets of the company were sold at a significant undervalue. The shareholder also claimed that various parties were involved in a conspiracy to effectively place the chain into administration with the intention of selling the assets cheaply to a competitor.

The Insolvency Practitioners were able to defend the allegations because they had kept exemplary records including meeting and telephone notes, and were able to demonstrate that they had followed a clear and audited process which informed their actions. They had actively marketed the business for sale, and had obtained up-to-date reports as to the market value of the property, and thus were able to evidence that the assets were not sold at undervalue.

Claims against auditors

Audit remains very much in the regulatory spotlight. According to ICAEW's 2020 Audit Monitoring Report[3], 9-10% of audits reviewed in 2017-2019 were referred for possible regulatory action, with a further 15-20% identified for improvement actions.

Increased corporate insolvencies and pre-pack administrations will only increase auditors' risk exposure. When companies fail, the insolvency practitioners involved will carefully examine whether any claims might exist against the companies' advisers. Often, auditors and accountants are near the top of that list. The recent decision in Assetco v Grant Thornton[4] allowed a company to recover trading losses from its negligent auditors which may encourage similar claims in the future.

The trend for requests for information from liquidators of former companies looking at potential claims against auditors is only likely to increase as the number of insolvencies rise. There is also some potential for claims by incoming insolvency practitioners against their predecessor – for example, for entertaining a creditors voluntary arrangement for too long and favouring certain creditors over others.

A further risk factor impacting on possible claims against auditors has arisen as a result of lockdown. Restrictions on travel and accessing sites has prejudiced the ability to gather evidence, complete audits and conduct risk assessments. It is likely that auditors will face difficulties acquiring documentation from clients, and it may be tempting for auditors to pass over evidence that they would have picked-up on in normal circumstances. The Financial Reporting Council introduced a new auditing standard ISA (UK) 570 which came into effect in December 2019 – the practical effect of which will be felt from 1st January 2021 onwards.

FRC have more recently published guidance for companies on the disclosure of risks and other reporting consequences – including recommendations of enhanced policies and procedures to support the accurate evaluation of 'going concern' assessments. The ICAEW has also published guidance and FAQs about conducting audits remotely.

ICAEW advise that they 'continue to see weaknesses in testing, insufficient scepticism and challenge of management, and inadequate documentation'. A precautionary approach is advised, ensuring that audit clients are challenged on information provided and any gaps or inconsistencies, with additional time allocated, particularly for complex audits, given the likelihood of delays in the provision of necessary information. Audit procedures should be updated to reflect these requirements, and processes put in place to ensure that the procedures are being followed properly in practice.

As investors turn their attention to businesses' environmental and corporate social responsibility credentials, auditors are increasingly being asked to review clients' ESG performance and reporting. We anticipate the increasing emergence of scandals regarding modern slavery in supply-chains, and alleged green-washing, alongside increasing financial and regulatory implications for the businesses involved. This is likely to be an emerging area of claims against auditors. How the terms of audit are scoped will be an important factor in determining which claims fall and which are successful.

[3] ICAEW Audit Monitoring Report 2020

[4] Assetco Plc v Grant Thornton UK LLP (2020)

Case study: Audit Negligence

A firm appointed as auditor to an overseas-regulated financial services company ('the company') received a claim against it from the liquidators of the company for negligence, breach of fiduciary duty, and an allegation of dishonest assistance in the commission of fraud.

The Auditor had not identified two transactions relating to the company reserves as fraudulent. Both transactions were worth several hundred million dollars, and, had these not been included within the company's assets, the company would not have been viewed as solvent and would not have retained its regulatory licence.

It was alleged that several details of the transactions were commercially nonsensical and ought to have raised suspicions. It was also alleged that the resignation of the Auditor the year after signing off accounts where issues had been raised suggested an existing awareness of irregularities at the time the Auditor signed off the previous year's audit.

A review of the audit file revealed that the firm's audit management software had not been used on several occasions, and when it had been used, it has been completed with little rigour. These failings had not been picked up in the sign-off process either, which appeared to be more of a 'tick box' exercise. A further factor identified was that the individual auditor had been able to accept the instruction despite not being experienced in this particular industry.

Risk management learning points

> Matter risk assessment and acceptance criteria should be clearly set out and include sign-off requirements where certain risk factors are triggered (including sector expertise)

> A risk matrix/checklist is advisable to assist identify fraud and other irregularities

> Audit Planning documentation should be comprehensive and systematic, and its completion meaningfully reviewed by the matter supervisor.

Tax advice & tax mitigation

Tax remains a ripe area for claims and we have seen a number of high-value claims relating to misinformation and/or advice on pensions (particularly re the Lifetime Allowance), employee share (EMI) schemes, correct use of reliefs available, and the administration of trusts.

While the number of tax mitigation schemes appears to be rising, according to HMRC, 'the market has moved away from top accountancy firms to boutique promoters'[5] with a decisive shift towards employment-based schemes targeted at middle income earners – particularly contractors.

We continue to deal with claims relating to tax mitigation schemes which failed after HMRC's stance had apparently changed or at least toughened. Given limitation, there are fewer claims relating to the 'old style' sale and leaseback/ tax rebate film finance schemes, but we continue to see claims relating to advice on the likes of Employee Benefit Trusts (following the Rangers decision) and failed Enterprise Investment Schemes. These claims often involve financial advisors as well but the claim for 'poor tax advice' or 'relying too heavily on tax scheme promoters' can fall to the accountant – especially where the accountant had a duty to warn of potential risks with the scheme (for example, that the tax benefits might be challenged by HMRC). Subject to the minimum terms, these claims can pose interesting questions from a policy coverage perspective.

M&A work

We anticipate a significant increase in M&A activity over the course of 2021/2022, which is likely to lead to increased claims. Mergers and acquisitions undertaken pre March 2020 may have not worked out well for the businesses involved, and, where that is the case there is likely to be an uplift in claims against advisers – whether well founded or not.

[5] HMRC Corporate Report: Use of marketed tax avoidance schemes in the UK 26 November 2020

Legal & regulatory changes

The FRC continue to investigate auditors, and there have been several investigations launched following on from high profile corporate insolvencies (Carillion, Patisserie Valerie etc.). The main areas of concern identified by the FRC in their last annual review are a failure to exercise professional scepticism (which has partly led to the consultation on fraud standards set out below), auditors being too close to company management (comprising their independence) and too much delegation of work to junior auditors.

The increase in corporate insolvency as the result of the Covid pandemic will inevitably lead to more FRC investigations. The FRC carried out a consultation in late 2020/early 2021 into the role of auditors and their responsibility to detect fraud, which is currently governed by ISA240. The FRC want to make an auditor's obligations clearer, which is likely to involve further burdens on auditors and require them to have a heightened awareness of potential fraud when conducting audits.

The UK government proposals for a new Audit, Reporting and Governance Authority to replace the FRC also heralds a radical shake up of the audit profession, which affected businesses will have to start preparing for. The recently published consultation highlights the crucial role of auditors in scrutinising businesses, advocates that audit reports "should be more forward looking and informative" – requiring a "new auditor mindset" and a business model separated from wider accountancy functions.

If your business has offices, or clients in Europe, you may well have to address some of the specific issues arising from the free-trade deal agreed with the EU on 24th December. You may have to register for VAT in EU countries you are providing services into. UK qualified staff working in Europe will no longer have their qualifications automatically recognised, and depending on the qualification and the country, may have to sit additional conversion exams. The situation appears particularly arduous for auditors, who require to be resident in France and Italy, and have to requalify in some other countries.

Data protection is as yet an unresolved Brexit issue – with a six-month extension during which data flow between the EU and the UK will continue as normal, pending the results of an assessment of UK data protection standards. You should therefore keep alert for any changes, assess how they could impact your business, and have contingency plans in readiness.

The FCA, and other professional regulators, continue to focus on AML. Be aware of proposals to extend the obligation to report annually on financial crime to a far wider range of businesses, regardless of their revenue.

While what remains of the DAC6 regime in the UK will be short-lived, firms should look out for the OECD Minimum Disclosure Rules that will supercede it. In the meantime, tax arrangements that fall within category D hallmarks (those designed to undermine reporting requirements or obscure beneficial ownership) continue to require to be reported in accordance with the existing DAC6 reporting deadlines.

We anticipate regulators taking a tough stance on firms that fail to meet regulatory obligations in 2021. We also anticipate a tough trading environment, and the gradual emergence of a recession-related wave of claims against professional advisers. Take the steps now to ensure that your business is well placed to weather the storm, and to take advantage of the opportunities that the disruptive environment offers.

Cyber risks & fraud

Cyber-crime and wider information security risks should be high on any professional services firm's agenda in 2021. There are very real concerns regarding the impact of the current cyber-crime wave which immediately followed the Covid-19 pandemic and businesses' 'dash to digital'. Firms may have deployed new digital services without sufficient consideration. This could result in substandard functionality and difficulty in extracting data – whether for meaningful management reporting, or for migrating data to a different service provider. More seriously, it could be responsible for errors occurring or not being picked up, or even lead to you committing regulatory breaches (for example, if your service provider does not store your client data in accordance with GDPR). At its worst, your roll-out of remote working could have actively exposed your business to malicious cyber-attack.

There is real concern that a rushed adoption of technical solutions could easily pose a threat to businesses at least as great as the current pandemic, given the exponential uplift in sophisticated cyber-attacks seen over the last year. This is no idle threat, and businesses should put cyber risks at the top of their risk agenda in 2021.

Using tools such as STORM Guidance's Cyber 3 Risk Assessment can help you identify vulnerabilities that you are unlikely to be otherwise aware of.

While businesses in March 2020 might understandably have cut corners to transition to remote working effectively, neither clients nor regulators are likely to be sympathetic in 2021 to such short-cuts should anything go wrong, so QBE's guidance on remote working should be revisited and any gaps in your processes addressed.

Risk controls & action points - summary

> **Build in robust risk assessment** within your matter inception process. Allocate more supervision and key-stage checks to high value and high-risk matters and ensure staff are well-trained on monitoring risk profile changes, reacting and escalating swiftly

> **Ensure that you have clearly defined your business's risk (and work-type) appetite** - and that this is applied in practice - ensuring that only the personnel with appropriate expertise take on work of the nature that you determine fits your business profile

> **Ensure that all client engagements are properly scoped and documented**, including clearly worded exclusions from scope. Include wording in your engagement that excludes responsibility for advising on future dates or events, such as the impact of future tax changes

> **Remind staff of the importance of maintaining a comprehensive file** including a written record of all advice given, and, where relevant, a clear audit trail justifying actions taken. This should be checked as part of regular supervision meetings and a programme of file audits

> **Review your template client letters and reports** to ensure that they adequately prompt consideration of, and flag, risk issues to clients

> **Remain alert to the risks of remote working:** ensure that supervisors check in regularly with their team and monitor workloads and ongoing files. Download QBE's Remote Working guidance for more information

> **Stay up to date with the latest tax law and related HMRC guidance.** Where tax law changes materially change the available exemptions and reliefs, alert existing clients to the changes and their potential impact

> If you are not already cybersecurity accredited (ISO27001, IASME, Cyber Essentials, Cyber Essentials Plus), **complete a QBE Cyber Risk Profiler cyber risk assessment** as an initial step towards accreditation

> **Review your IT and data management policies and procedures** to ensure that they contain adequate information security protections (e.g. banning the use of memory sticks and local storage of client or company data; firming up on employee exit processes).

Audit-specific risk controls & action points

> **Include consideration of worst-case scenarios** when assessing forecasts

> **Use a flowchart** or similar tool to work through various going concern scenarios to identify the appropriate form of audit opinion

> **Ensure that your file includes thorough documentation of thought processes** supporting conclusions and demonstrating scepticism and challenge of management

> Follow the ICAEW best practice guidance on remote audits.

Additional resources

> Download QBE's suite of Risk & Compliance Template Policies and Procedures.
Contact us if you do not already have access to QRisk, QBE's risk management platform.

> Assess your Cyber Risk using QBE's Cyber Risk Profiler

> Access additional support from QBE's specialist panel of consultants, covering a range of quality and other ISO accreditation services, risk and compliance training, and cyber, fraud, information security, and business continuity advice.

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