FAO Phil Fitz-Gerald
Financial Reporting Council
8th Floor
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24 July 2015

Dear Sirs,

Improving the Quality of Reporting by Smaller Listed and AIM Quoted Companies – Response to Discussion Paper

PricewaterhouseCoopers LLP welcomes the opportunity to respond to your discussion paper on improving the quality of reporting by smaller listed/AIM companies, and thanks you for your work in this important area. In particular we hope that your presentation of a broad set of potential solutions will encourage engagement on your proposals from relevant stakeholders.

You have asked respondents to consider the following questions:

- To what extent do you recognise and agree with the issues raised in the report regarding the quality of reporting by smaller quoted companies?

- Do you consider that the actions proposed are (i) a proportionate response to the issues identified; and (ii) an adequate response to the issues identified?

In answering these questions we have considered a number of broad themes and set out our observations below.

Quality of financial reporting

We agree that the quality of financial reporting can be more variable amongst smaller listed and AIM companies. We are keen to support you in your drive to raise that quality and recognise that we have our part to play in that. Some of the areas of financial reporting that you have identified in the consultation document as needing improvement would appear more relevant to smaller and AIM companies, but other areas we believe would also be relevant to the quality of larger company financial reporting.

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Whilst several of the areas noted as regularly giving rise to comment are, we agree, important to investors (business review and strategic report, accounting policies, better descriptions of complex or unusual transactions and cash flow statements) some of the more detailed points of disclosure might have differing importance for different investors, and it should be acknowledged that at this end of the market there is a very wide range of investors with very different needs. It is important, therefore, that any solutions you propose focus more on improving quality in the areas which are of importance to all investors. We would encourage you to ensure that any proposed solutions are capable of being useful also to larger listed companies.

We support your desire for greater dialogue between investors and smaller listed companies, to demonstrate to those companies the value in their financial reporting. To further this, we suggest that you consider a Financial Reporting Lab project that focusses only on smaller listed company reporting, to understand in depth what would constitute best practice in the areas that are currently boilerplate, or in which you believe that companies are struggling to deliver the information that investors have told you they want.

In particular, we highlight below our views on the extent to which a reduced disclosure framework could be transformational to quality of financial reporting.

Capital markets efficiency

We agree that UK and European companies seem to rely more upon debt than equity for financing, compared to their US counterparts and we are supportive of any initiative that helps to open up equity investment for smaller entities. It's also worth reflecting on how other factors influence this preference for debt over equity – for instance the tax deductibility of interest payments in the UK, which in our view plays a large part in the choice of financing. There is also a barrier thrown up to retail investment by the behaviour of citizens in the way that they save, invest and plan for both wealth creation and retirement. We appreciate that neither of these are in the FRC's remit to change. With that mind, we don't necessarily see an imbalance in the way that the capital markets are working that is caused only by the quality of financial reporting and would urge that any proposals are measured, proportionate and reflect extent to which high quality financial reporting is likely to act as a lever of change to investment models.

It's also important when considering how to respond to these issues to remember the fundamental premise of the AIM market and how that is different from the main market. AIM's purpose is to provide entities in the early stages of their business development with access to equity funding. The market is directed at those professional and sophisticated retail investors who understand that early stage, fast growth businesses can carry a greater degree of risk. AIM sets out to balance regulation and the standards to be met with the need to facilitate entrepreneurial growth. Our experience of this market is that there is at best limited appetite for further regulation, because the current level of regulation is exactly why companies come to AIM and what investors expect for the companies in which they invest. The consequential increased investment risks which flow from this form of regulated environment should, we believe, be factored into market pricing. Whilst this doesn't excuse poor quality financial reporting by market traded entities, it does challenge the suggestion that further regulation is the solution to the financial reporting quality issue. We suggest that, in keeping with the philosophy of AIM, you seek to encourage the London Stock Exchange to develop a market driven solution, promoting dialogue between investors and companies to determine what aspect of current regulation is important to change.

Notwithstanding the above, we support the proposal to shorten the time period that AIM companies have to finalise their annual reports from six to four months, to bring it in line with the main market. In our view, this won't change the level of effort that companies have to put in to produce the annual report, just the timing of this effort, and may go some way in reinforcing to AIM companies the fact that their financial reporting is important.

Simplified disclosure

We agree that it is desirable to have comparability of accounting bases for the effective functioning of capital markets and that the financial reporting for all entities with listed securities should be anchored in the existing frameworks developed by the IASB. But with a reduction in regulation in mind, we are supportive of your proposal to consider whether the Capital Markets Union proposals provide an opportunity to consider options for a reduced disclosure framework. We support the IASB's overall objectives in pursuing its Disclosure Initiative project, but think there may be opportunities to go further, particularly in respect of AIM companies.

We see the challenges that smaller companies face in dealing with the volume of disclosure requirements within IFRS, particularly where the simplicity of their business model leads to many of the disclosures not being particularly insightful. In particular, we see that those preparing the accounts of smaller companies struggle in the more technical areas and lack confidence. This lack of confidence, we believe, may lead them to seek the safety of 'boilerplate' disclosure, which in turn may lead to the view that smaller listed companies expressed to you around the level of engagement they perceive from investors on their financial reporting. We think that a reduced disclosure framework would allow these smaller companies to focus their efforts and energies on improving the disclosures that remain, and that you have identified as important to investors, such as a better description of the business model or more detail on one-off transactions.

Of course, we acknowledge that the requirements of European law would be a barrier to any unilateral reduction in disclosures presented by companies listed on the main market. Such companies are required to prepare their financial statements in accordance with IFRS as endorsed for use within the EU, and that includes all of the disclosure. But we believe it is legitimate to explore whether a unique framework, similar to that devised in FRS 101, could be developed solely for AIM companies.

Parallel to this, we support the development of additional guidance around materiality in disclosures, to help companies and their auditors understand what would influence or change investors' decisions. This is essential if all parties are to identify where reporting can be made clearer and more concise as well as where to seek to expand disclosure. In this regard, we await the IASB's imminent draft practice statement on materiality, and will respond in due course.

Corporate governance

Although we see the application of the Corporate Governance Code ('the Code') to be a differentiator between premium main market listed and many standard listed main market and AIM listed companies in their focus on the quality of financial reporting, we would urge caution over imposing greater corporate governance requirements for standard listed main market and AIM companies.

Introducing the extended auditor report, for example, would require the company to adopt those elements of the Code that are essential to complement the extended auditor reporting with the company's views. It might be more proportionate to ask the FCA or the London Stock Exchange to develop a small number of corporate governance principles for standard main market and AIM companies to sign up to, with a 'comply or explain' reporting basis that may often tip towards the 'explain' end of the spectrum, rather than impose more of the Code on entities that are not of the type for which it has been developed.

Resources

Your comments on adequate time and resource strike a chord. Particularly at the smaller end of the AIM market, the finance team might be very small and its focus understandably less on the intricacies of IFRS and more on the commercial aspects of running the business. We support your discussion with professional bodies about how they can play their part in assisting individuals to keep up to date. What might be more powerful, though, is the provision of guidance by the FRC. But it is important to keep the volume of any guidance manageable in order for it to make the impact that is intended - for example a short video on key points for management to consider when preparing their annual report, drawing upon your knowledge of the specific issues you want to see addressed or that you believe might be more difficult for preparers to deal with. Similarly, a celebration of best practice examples of financial reporting would contribute towards a better understanding of what good financial reporting looks like.

In reflecting on the barriers to better financial reporting, we see a need to create an incentive for improvement. As things currently stand, an entity with limited financial reporting resource that wants to make changes to its existing reporting and disclosures (which have already passed through both its auditors and financial reporting review oversight without comment) has only the downside of regulatory censure should it make changes and not quite get them right. We suggest the FRC consider some options in this area being:

- At least initially, a lighter regulatory touch for smaller entities, with a focus on censure for fatal flaws only; and/or

- creation of a safe environment for experiment by these entities, with coaching or provision of learning only from the FRC in the first year that reporting change is made, but an expectation that any improvement points that an FRC review notes are actioned by the company in year two and beyond.

Implications for audit firms

We do not see a need for change of the ethical rules regarding the provision of accounting advice by audit firms. Our engagement teams already provide accounting advice to our smaller listed company clients as matters arise on the audit as envisaged by the Ethical Standards as currently written. However we would welcome anything that gives further clarity over appropriate practice in this area, as we consider independence to be one of the auditor's highest priorities, not least because this might give audit committees the ability to better judge whether they can engage auditors to provide accounting advice. It's important though that any clarification isn't moving the boundary of what is permissible back from where it currently is, as we don't think that would be effective in improving the quality of financial reporting.

We do not believe that a special accreditation in respect of listed company auditing should be a pre-requisite to becoming a Responsible Individual. Within PwC, as a general rule, our new Responsible Individuals don't take on listed company audits until they have acquired relevant on the job experience of listed company audits at a senior level. We recognise that not all audit firms may have sufficient resource to take the same approach and we encourage you to give thought to what resources could be available to Responsible Individuals who are taking on the role of engagement leader or review partner on a listed company, for the first time.

The way forward

It is important to think not just about solutions for today but to look at what the answer to these questions might be in five or more years' time, anticipating any changes in reporting from paper-based to real-time digital information. There is an interesting dichotomy at play in that quality and timely information is a requirement of an efficient market, but at the same time some investors are encouraging companies to provide less information (that is, quarterly reporting) so that they can focus on business fundamentals.

We look forward to playing our part in helping you shape and implement changes to help smaller and AIM listed companies achieve better quality financial reporting. If there are any matters you would like to discuss further, please contact Peter Hogarth on 020 7213 1654.

Yours faithfully

PricewaterhouseCoopers LLP

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