ICAEW REPRESENTATION 103/15

Improving the Quality of Reporting by Smaller Listed and AIM Quoted Companies

ICAEW welcomes the opportunity to comment on the discussion paper *Improving the Quality of Reporting by Smaller Listed and AIM Quoted Companies* published by Financial Reporting Council in June 2015, a copy of which is available from this link.

This response of 14 August 2015 has been prepared on behalf of ICAEW by the Financial Reporting Faculty. Recognised internationally as a leading authority on financial reporting, the Faculty, through its Financial Reporting Committee, is responsible for formulating ICAEW policy on financial reporting issues and makes submissions to standard setters and other external bodies on behalf of ICAEW. The Faculty provides an extensive range of services to its members including providing practical assistance with common financial reporting problems.

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MAJOR POINTS

A promising start, but more analysis needed

1. ICAEW is a strong supporter of efforts to encourage high quality reporting by smaller listed and AIM quoted companies (hereafter referred to as 'smaller quoted companies', although we note that there other relevant exchanges in the UK) and to consider how such companies might be helped to achieve appropriate improvements. Extensive research undertaken by ICAEW in 2006/2007 in advance of the establishment of the Financial Reporting Faculty identified hard-pressed finance directors and other members of finance teams in smaller listed companies as one of the groups most likely to welcome further practical support in their financial reporting, and indeed many went on to join the Faculty.

2. The findings of the FRC project and any actions taken by the FRC and other UK organisations are likely to be of interest in the rest of the EU and indeed farther afield. We would be keen to aid promulgation of the findings and suggest where coordination of actions with others might be helpful.

3. We are pleased to note that the FRC has concluded that the quality of reporting by smaller quoted companies is generally of a good standard. This is an encouraging message, and while the focus of the paper is perhaps inevitably on the need to improve, it is important to draw attention to and applaud existing good practice.

4. The FRC has made a number of helpful observations in the paper. There remains much to do, however, to ensure that the causes and effects of the issues identified are clearly understood and that any actions taken are proportionate and effective. This is particularly important in view of the diverse nature of the companies under review in this study: understanding this diversity is fundamental to any meaningful analysis of the findings and consideration of possible actions. There is a risk of presenting a final set of proposals that embodies something of a 'one size fits all' approach, rather than the tailored set of proposals we think is necessary. We have developed this point more fully in paragraphs 32 to 35 below.

5. Further analysis should extend to a careful assessment of the costs to business associated with any proposed FRC actions, which must be clearly proportionate to the pervasiveness and economic significance of the issues. From this starting point the FRC will be better able to develop or encourage more effective and tailored actions that have a demonstrably beneficial impact on the quality of reporting by smaller quoted companies and on their ability to attract investment.

6. Finally, it is important to recognise that improving the quality of reporting by these companies will require concerted effort by all stakeholders, and is likely to take some time to achieve. ICAEW members play a major role in the sector, as preparers, auditors and investors, and we stand ready to play our part in this process, as indicated below in our detailed comments. It may be that there is a need to find new and innovative ways to encourage communication between regulatory bodies, companies and investors to underpin a robust and effective regulatory system that monitors quality over time, enables all stakeholders to contribute views on the subject and takes appropriate action where necessary. The joint FRC/ICAEW event on 13 November on smaller quoted company reporting will provide a timely opportunity to identify and agree an appropriate response to the issues raised in the discussion paper.

FRC recommendations: our key observations

7. **Tone at the Top** - we strongly agree with the FRC's finding that 'tone at the top' plays an important role in ensuring high quality reporting. As discussed in more detail in paragraphs 25 to 26 below, this requires further analysis, with sufficient emphasis on the responsibility of directors to ensure that the financial statements provide a true and fair view.

8. **Resource constraints** - we recognise the resource constraints identified in the paper, and believe that the analysis of the possible solutions could be extended. In particular, the FRC has not explored the option of a smaller quoted company seeking accounts preparation services from an accountancy firm that is not its auditor. We are also unsure of the merits of the proposals for enhanced CPD training for finance staff. There is a distinction between an individual's role in day-to-day accounting and management reporting, for which no evidence is presented of insufficient training, and involvement in the annual accounts preparation exercise. The accountancy bodies, moreover, already monitor whether members are undertaking appropriate CPD. It might however be useful for ICAEW and other bodies to survey their members working as finance staff in smaller quoted companies to identify any unmet training needs and to consider providing additional targeted CPD courses.

9. Resource issues are discussed in more detail below in paragraphs 39 to 43.

10. **The role of auditors** - we believe the rules over the extent to which auditors can advise companies in relation to their accounts are clear. However, if the FRC concludes that there is evidence of uncertainty in this area, we would be pleased to discuss the need for clarification. In our view, there is scope for the audit profession to play a more significant role in improving the quality of smaller quoted company reporting by providing accounting advice and services to non-audit clients.

11. The role of auditors is discussed in more detail below in paragraphs 29 to 31.

12. **Corporate governance arrangements** - we welcome the debate initiated by the FRC about possible changes to corporate governance arrangements applicable to smaller quoted companies and look forward to playing an active role in developing practical and proportionate solutions to the issues identified.

13. In terms of specific proposals, the FRC's suggestion that AIM companies 'consider' appointing a non-executive with relevant financial reporting experience has some merit, and suggest that further thought is given to how this would work in practice. While the idea that AIM companies consider adopting the principles of accountability set out in Section C of the Code, particularly in respect of audit committees, would, in many cases, be disproportionate, it might be useful instead for guidance to be produced explaining which aspects of the Code might be more relevant to certain types of company or to explore the pros and cons of requiring reference by all AIM companies to a tailor-made Code. Finally, we agree that it would be helpful to explore the usefulness of accessible, practical guidance for audit committees (or for the board as a whole acting as such), dealing, for example, with the evaluation of the adequacy of the financial reporting function and changes to standards/requirements.

14. The issues around corporate governance are discussed in more detail below in paragraphs 44 to 48.

Financial reporting standards

15. The discussion paper proposes that the FRC consider whether the debate over Capital Markets Union in the EU provides an opportunity to develop a differentiated disclosure framework for smaller quoted companies, building on the IFRS-based approach adopted in UK GAAP.

16. We recognise that IFRS are complex standards and that their application by smaller companies can be challenging, not least in terms of the disclosure regime. Our impression to date, however, is that UK investors would not wish to see smaller quoted or AIM companies moving to an IFRS-lite regime, and we are not convinced of the merits of such a change. IFRS reporting is widely understood by investors and it is generally accepted that, while not perfect, IFRS provides high quality financial information. It would in our view also be preferable to encourage more radical thinking by the IASB in its disclosure project to make IFRS disclosures proportionate for all companies using the standards.

17. These issues are discussed in more detail below in paragraphs 49 to 53. We would be pleased to participate in any further consideration by the FRC about the merits of change in this area, and to better understand investor views regarding arguments for an IFRS-lite solution.

RESPONSES TO SPECIFIC QUESTIONS

Question 1:

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

A balanced view is required

18. We welcome the FRC finding that generally the quality of reporting by smaller quoted companies is regarded by investors and other users of their financial statements as timely and of a good standard. We are also pleased to note that, while the FRC has outlined a number of areas for improvement (pages 12-14), the findings do not suggest fundamental concerns. This is an encouraging message, and while the focus of the paper is perhaps inevitably on the need to improve, it is important to draw attention to and applaud existing good practice.

19. That is not to say that it is not valuable to highlight areas for improvement. Indeed, we recognise that some of the areas identified in the paper can be problematic for smaller companies and can sometimes lead to sub-standard reporting, for example in relation to cash flow statements, disclosure of accounting judgements and estimates, and disclosure of accounting policies. However, the FRC needs to be very clear about what it is seeking to achieve and why, and balance this against what is appropriate and proportionate for these companies.

Assessing investor views

20. We are pleased to note that the FRC has been in close contact with investors when gathering information on this topic. It is also encouraging to note that investors say that they find the annual report to be a valuable source of information, particularly when there is generally less analyst coverage and reliable publicly available information for such companies. However, we believe a degree of caution is required when analysing the findings in this area, as discussed in the following paragraphs.

21. The FRC is proposing that more pressure be placed on investors to engage with companies, for example, through providing feedback on their annual reports. We understand the rationale behind this proposal and agree it may be helpful in certain cases. However, while publication of the audited financial statements is a critical aspect of the process for maintaining investor confidence in management, we think it is important not to overemphasise the need for more investor engagement on an ongoing basis. The absence of engagement in this respect does not necessarily suggest an underlying problem, or at least one that demands FRC action. It may be that investors are engaging adequately with companies in terms of other sources of information, eg, preliminary announcements, and subsequently trust the information included in the audited financial statements, which serve simply as confirmation of what has already been reported. The lack of engagement may be an indication that, in fact, all is well as far as investors are concerned.

22. Equally, investors themselves are likely to be resource-constrained and unable to engage actively with smaller quoted companies on a regular basis. We consider in paragraphs 36 to 38 below what actions might be taken instead to enhance companies' understanding of the importance investors attach to the annual report, even if they do not express this sentiment through active engagement.

Understanding the diversity of smaller quoted companies

23. In taking this project forward, the FRC needs to consider sufficiently the diverse range of companies under review. Understanding this diversity is fundamental to any meaningful analysis of the findings and consideration of potential actions. For example, the review includes both companies listed on the main and AIM markets. Yet these markets are targeted at different types of business and are subject to different rules; for example, companies listed on the main market are required to apply the UK Corporate Governance Code, whereas AIM companies are not. These differences are particularly important when analysing the findings relating to corporate governance arrangements and the cost-effectiveness of new requirements or recommendations in that area.

24. In addition, there is diversity within the AIM market itself which can influence a company's perception of the benefits of good quality reporting. A company that has sought admission to the AIM market for a one-time capital raising may not be especially interested in investor views on the importance of good quality reporting, particularly where there is only a small free float and a limited (potentially illiquid) secondary market in the shares. On the other hand, an AIM company with many shareholders, expecting to seek additional funding to aid its growth, is more likely to want to see value reflected in the secondary market share price and to maintain an ongoing relationship with the market and investors. Similarly, much can depend on the spread of investor holdings at any one time. These differences are important, as it may be that the issues identified by the FRC vary substantially depending on nature of the company.

Tone at the top

25. We strongly agree with the FRC finding that 'tone at the top' plays an important role in ensuring high quality reporting. In our view, a commitment from the board for high quality reporting is one key element in any drive towards major improvements in this area, for example by ensuring that sufficient resources are allocated to the preparation of the financial statements.

26. Efforts to improve financial reporting by smaller quoted companies should encourage directors to have regard to best practice in the structure and content of financial statements, but alongside sufficient emphasis on their legal responsibility to ensure that the financial statements provide a true and fair view. In places, the FRC seems to place an undue emphasis on the role of auditors, rather than on the directors, whose role as regards to the preparation of the financial statements is paramount.

Resourcing

27. We understand that time and resource constraints are often a challenge for smaller quoted companies and that this can have an impact on the quality of financial reporting. We also recognise that IFRS can be complex and that this can add extra pressure on finance teams when preparing the financial statements. This may be particularly problematic when a company enters into complex transactions, as without the appropriate expertise, the degree of complexity and corresponding accounting implications may not be fully appreciated.

28. The FRC has so far focussed on the ongoing availability of in-house resources when considering this matter. We suggest that the discussion is widened to encompass how finance resource and advice might best be sourced. These issues are discussed in our response to Question 2 below.

Role of auditors

29. In our opinion, the paper does not recognise sufficiently the constraints that the Ethical Standards impose regarding an auditor's ability to influence the overall quality of the financial statements over and above the hurdle required for them to show a 'true and fair' view. The Ethical Standards do require auditors to feed back observations during the course of their audit and this plays a major role in driving up quality towards an acceptable level. However, beyond ensuring that the accounts meet the true and fair test, auditors have little leverage, and when companies produce their accounts late into the audit process, the auditor's suggestions for improving the quality of the accounts are inevitably made late too and are likely to be received by the directors with a mind-set of seeking the minimum improvements needed to secure an unqualified opinion, rather than improvements in the overall quality of the accounts.

30. In this regard, the FRC notes that the precise boundary for the restriction on auditors from providing accounting advice to smaller quoted company clients is 'open to interpretation' and that as a result many err on the side of caution when providing advice. If this is the case, it may at least be partly because of a concern by those firms about potential criticism from Audit Quality Review inspectors. ICAEW has over the years issued FAQs in this area, following consultation with then-APB staff, where particular issues were noted, and believes that the rules are actually very clear. However, if the FRC has evidence that there is uncertainty in this area, we would be pleased to discuss ways of improving clarity, while seeking to avoid setting hard and fast rules that tend to result in unintended consequences.

31. We note that there was limited support for a relaxation of the Ethical Standards in this area. This is appropriate in terms of the underlying requirements, as it is importance for independence to be maintained for all audits. There may be scope for reviewing some of the detailed requirements that apply additionally in respect of public interest entity audits, as discussed below in paragraph 41, but we note that current EU legislation would not allow any significant relaxation.

Question 2:

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?

Developing a calibrated response

32. We have already indicated above that smaller quoted companies, as defined for the purpose of this review, should not be considered as a single population. To start with, the extent to which the quality of reporting is an issue will vary significantly. Some companies will be preparing financial statements considered to be of a reasonable quality but capable of improvement, while others will have more significant issues and may even be preparing financial statements of an unacceptable standard. Furthermore, within either category there will be different types of companies, subject to different rules and with different perceptions of the costs and benefits associated with improvements in the quality of financial reporting. As a result, the relevance of the issues identified in the FRC paper is likely to vary according to the individual circumstances of the company.

33. As explained above, the FRC needs to ensure that it considers to a sufficient degree how the market is segmented in this way before implementing any of its proposed actions, rather than adopting a rather ‘one size fits all’ approach. We would in fact prefer to see a far more calibrated set of proposals. For example, for companies preparing financial statements that do not meet an acceptable standard, the focus should first and foremost be on compliance. Regulators might therefore consider whether any more needs to be done to ensure that there is sufficient emphasis on admission and on an on-going basis on the financial reporting aspects of the requirements of AIM or the main market, as applicable, for example, for an AIM company, by its NOMAD, and by the UKLA and the London Stock Exchange. It will also be important to ensure that directors understand their duties with regards to the financial reporting and to help establish an appropriate ‘tone at the top’. ICAEW would be pleased to discuss with the FRC how this might be achieved.

34. These actions might be unnecessary or even disproportionate for companies that are already preparing financial statements of reasonable quality. In this case, the focus should be on how to encourage further improvements, for example, by bridging the communication gap between companies and investors. Having regard to investors’ limited resources, we would be pleased to discuss with the FRC how this might be achieved, perhaps by making direct contact with chairmen of boards and audit committees to explain the value that investors place on the financial statements and to highlight key areas of focus. This might include encouraging a ‘clear and concise’ approach to the drafting of the accounting policies and other disclosures. In addition, it may be helpful to highlight how good quality reporting provides investors with useful information that may help companies to raise additional funds.

35. If quality is already taken seriously by the company, relatively simple actions such as this may be sufficient to secure significant improvements.

Communication with investors

36. As already noted, we agree that encouraging communication with investors can be an effective way of improving the quality of reporting, especially for companies with a large number of shareholders. There may be scope for the UK listing authorities to do more in this respect. For example, they might outline particular areas of focus for investors and other organisations might then produce guidance if deemed necessary.

37. We also agree with encouraging more smaller companies to participate in the work of the FRC's Financial Reporting Lab, developing case studies and examples of best practice for the sector and exploring perceived challenges, such as concerns over commercial confidentiality. We do, however, recognise that the practicality of this proposal may be limited by the resource constraints these companies are subject to. The FRC might, perhaps, seek to identify from their strategy statements smaller quoted companies with a growth agenda involving ongoing access to the markets and target them for participation.

38. ICAEW is an active supporter of the Lab's activities and would be willing to consider how we might help further, for example in the identification of potential participants.

Resourcing – preparers and auditors

39. As mentioned above under Question 1, the FRC has focussed heavily on the ongoing availability of in-house resources, rather than considering the various potential ways companies might source relevant finance expertise. However, in our view, employing an accountant full time who has to keep up to date with all financial reporting developments, but only infrequently prepares financial reports, will often not make economic sense.

40. We also note that the FRC has not yet performed any cost analysis in this area, and identifies working capital challenges as a barrier to companies providing more dedicated resource for financial reporting without exploring in any detail other options that may be available in this context. For example, an appropriate and cost-effective solution for some smaller quoted companies would be to seek accounts preparation services from an accountancy firm that is not its auditor. We also discuss below in paragraphs 44 to 45 the benefits that an experienced chartered accountant can bring to business in the context of non-executive appointments; there may be in fact a number of ways that this experience might be brought to bear in relation to smaller quoted company reporting. These potential solutions should be developed and explored further.

41. Our understanding is that, for listed companies, the current Ethical Standards prohibit the provision of accounting services by the auditor, regardless of the company's size or preparedness to pay for these services. We acknowledge that the current standards are being reviewed and believe that whether the ethical requirements applicable to public interest entities continue to be extended to UK listed entities that do not fall within the EU public interest entity definition is one of the issues being considered. In our view, the audit profession can play a major role by providing accounting advice and services to non-audit clients, although it would be important to acknowledge that this is a separate service with an associated cost. It would also be important not to make changes lightly to the requirements for auditor independence and objectivity, attributes highly valued by investors. In this connection, we note that the FRC found limited support across all groups of stakeholders for a relaxation of the Ethical Standards.

42. We are unsure of the merits of the FRC's proposals for ensuring more focussed training for finance staff in order to fulfil CPD requirements and for a CPD regime that does more to help finance staff to keep up to date. There is a distinction between an individual's role in day-to-day accounting and management reporting, for which no evidence of insufficient training is presented, and involvement in the annual accounts preparation exercise. The accountancy bodies already, moreover, monitor whether members are undertaking appropriate CPD. It might, however, be useful for example for ICAEW and other bodies to survey their members working as finance staff in smaller quoted companies to identify any unmet training needs and, if thought to be a cost-effective way for such companies to access the required expertise, to consider providing additional CPD training courses.

43. We note that the FRC is proposing to review whether the process of granting Responsible Individual (RI) status could be improved to ensure that audit partners are suitably qualified and experienced to carry out audits of listed or AIM quoted companies. However, the FRC has presented no evidence in the report to suggest that those accorded RI status are not already suitably qualified and experienced. We therefore question the need for such a review.

Corporate Governance

44. The FRC's suggestion that AIM companies 'consider' appointing a non-executive with relevant financial reporting experience has some merit. We suggest that further thought is given to how this would work in practice.

45. One possible issue is the availability of sufficient numbers of suitable individuals attracted to the role to satisfy this proposal. We also believe that it is more likely that smaller quoted companies will seek to appoint non-executive directors for their commercial acumen rather than their expertise in financial reporting. This is an understandable bias, but we would expect the appointment of an experienced chartered accountant as a non-executive to be highly beneficial, both in terms of business skills and reporting experience. It will of course be important when considering how this option might be taken forward to have due regard to the expected costs and benefits of appointing a non-executive director, including in comparison to other potential options.

46. The diversity of companies within the review also needs to be taken fully into account when changes are proposed regarding corporate governance arrangements. For example, the FRC suggests that AIM companies consider adopting the principles of accountability set out in Section C of the Code, particularly in respect of audit committees. However, application of the Code at the AIM market level would, in many cases, be disproportionate. In our view, it would be more useful for some guidance to be produced explaining which aspects of the Code might be more relevant to certain types of company. Alternatively, the pros and cons of requiring reference on a comply or explain basis by all AIM companies to a tailor-made Code might be explored.

47. We agree that it would also be helpful to explore the usefulness of accessible, practical guidance for audit committees (or for the board as a whole acting as such), dealing, for example, with the evaluation of the adequacy of the financial reporting function, changes to standards/requirements, and communicating areas of focus for investors.

48. While further discussion and debate is needed about possible changes to corporate governance arrangements applicable to smaller quoted companies, we welcome the debate initiated by the FRC and look forward to playing an active role in developing practical and proportionate solutions to the issues identified.

Financial reporting standards

49. The discussion paper proposes that the FRC consider whether the recent EC Capital Markets Union paper provides an opportunity to develop a differentiated disclosure framework for smaller quoted companies, building on the IFRS-based approach adopted in UK GAAP.

50. We recognise that IFRS are complex standards and that their application by smaller quoted companies can be challenging, not least in terms of the disclosure regime. We therefore agree that the FRC should continue to seek to ensure that the frequency of changes to IFRS standards is proportionate and takes account of their application by smaller companies. We think that the successful completion of the IASB's disclosure initiative could help significantly in this context, and that the IASB should be encouraged to make more substantial progress on this project to make the costs and efforts of compliance with the disclosure regime proportionate for all companies. Indeed, it would in our view be preferable to encourage more radical thinking by the IASB to make IFRS disclosures proportionate for all companies using its standards. We also recognise that regulators have a role to play when it comes to encouraging smaller quoted companies to apply the materiality test to their disclosures; a proportionate approach is needed to ensure that companies have the confidence to exclude immaterial disclosures, and the opportunity should be taken to question disclosures that appear to be superfluous.

51. Our focus in considering the case for a differentiated disclosure regime for smaller UK listed companies is on ensuring that investors have access to the information they need to make informed economic decisions. Our impression to date is that UK investors would not wish to see smaller quoted or AIM companies moving to an IFRS-lite regime. IFRS reporting is widely understood by investors and it is generally accepted that, while not perfect, IFRS provides high quality financial information that can be compared both domestically and internationally on a consistent basis. It also makes sense for companies listing on a growth market such as AIM, with a view to graduating in due course to the main market, to use the standards applicable to that market. We are unsure, too, how far moving to a differentiated disclosure regime would address the common issues identified by the FRC in the discussion paper.

52. We would, however, be pleased to participate in any further discussions in the UK about the merits for change in this area, and to better understand investor views.

53. Another approach noted in the Capital Markets Union green paper is to develop an entirely new common European standard. This approach is fraught with risks and more likely to be counterproductive. We envisage that any attempt to introduce a new European standard would engender disagreement and delays that would make an efficient process and the production of a high quality, credible standard highly unlikely. In our comments on that paper we strongly discouraged this course of action. In any case, if an alternative standard to IFRS were selected, it would have to be aligned to IFRS, to facilitate transition to full IFRS as companies grow and to minimise the effort required by investors when familiarising themselves with a new set of requirements..