Association of Accounting Technicians response to Improving the Quality of Reporting by Smaller Listed and AIM Quoted Companies

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1. Introduction

1.1. The Association of Accounting Technicians (AAT) is pleased to have the opportunity to respond to the Financial Reporting Council (FRC) consultation paper “Improving the Quality of Reporting by Smaller Listed and AIM Quoted Companies” (condoc), released on 2 June 2015.

1.2. AAT is submitting this response on behalf of our membership and for wider public benefit.

1.3. AAT has added comment in order to add value or highlight aspects that need to be considered further.

1.4. AAT has focussed on the operational elements of the proposals and has provided opinion on the practicalities in implementing the measures outlined.

1.5. Furthermore, the comments made by AAT reflect the potential impact that the proposed actions in the consultation would have on businesses, many of which employ AAT members.

2. Executive summary

2.1. It is implicit that investors require high quality corporate reporting in order that they can make reasoned investment decisions and they will often use an entity’s annual report as a primary source of information to assess the performance of the entity over the year. It is generally understood that investors see the annual report as a crucial document to be used by them in their decision-making process as it provides a reasonable level of assurance due to the work undertaken by the auditors to arrive at an opinion as to whether the financial statements give a true and fair view (para 6, Executive Summary, condoc).

2.2. Whilst it is generally felt that corporate reporting by smaller listed and AIM quoted companies in the UK is of a good standard, it has been suggested by both the FRC and investors that there is room for improvement in a number of key areas (para 6, Executive Summary, condoc) (3.1, below).

2.3. The issue of poorer quality corporate reporting appears to be most significant for smaller listed and AIM quoted companies hence the encouraging of smaller listed and AIM quoted companies to provide better and more relevant information is suggested to potentially open up greater access to capital by attracting investors (3.23, below).

2.4. It is suggested, and AAT agrees, that there is a perception that annual reports of smaller listed and AIM quoted companies are not read by investors and hence become an exercise in compliance as opposed to one which adds value to the company (3.23, below).

2.5. Furthermore, the condoc cites ‘boiler-plating’ as a continuing problem (3.3, below). It is AAT’s view that boiler-plate accounting policies and disclosures are of little benefit to users of the annual report. In that, they are not entity-specific and as a result fail to disclose the sort of entity-specific information which users, investors and potential investors (stakeholders) require in order to make reasoned decisions in respect of such matters as the financial performance and wellbeing of the reporting entity.

2.6. AAT acknowledges that corporate reporting for smaller listed and AIM quoted companies can prove difficult for some boards – particularly in respect of the tailoring narrative required for inclusion in disclosure notes so as to make them entity-specific (3.10, below). Currently auditors of the company are very limited in terms of the amount of assistance that they can provide to a company in respect of financial statement preparation as the auditor's ethical standards inappropriately deny smaller quoted companies access to specialist skills.

2.7. This is further compounded where an entity's board believe that investors do not read the annual report (3.1, condoc).

2.8. AAT has concerns that a lack of up to date knowledge or sufficient level of skill is being given as one of the reasons for poor quality reporting in the FRC's condoc; particularly in relation to the role of continuing professional development (CPD) and the proposed approach for resolving these difficulties via professional bodies. As set out at 3.12 to 3.14 (below) it is AAT's view that accountants and auditors could benefit from the additional guidance from within IFRS or from other third–party material to help them in getting the required disclosures correct as this will help them interpret exactly what is needed from a disclosure point of view.

3. AAT response to the consultation paper on Improving the Quality of Reporting by Smaller Listed and AIM Quoted Companies

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?

3.1. AAT acknowledges that there is room for improvement in the field of corporate reporting for smaller listed and AIM quoted companies. The overall quality of financial reporting has been noted as generally good (para 6, page 6, condoc) and therefore AAT deduces that the objective of this consultation is to further improve financial reporting of smaller listed and AIM quoted companies rather than to address a severe shortfall in the current standard of reporting.

3.2. AAT is also of the view that some boards consider the annual report as more of a compliance exercise rather than a tool to be used to attract investors 3.1 (condoc).

3.3. In addition AAT recognises the use of boiler-plate disclosures (page 28 'Accounting policies', condoc) as an inherent problem for a significant proportion of companies[1] and one which is not necessarily confined to smaller listed and AIM quoted companies.

3.4. The issue concerning the length and complexity of annual reports has been an ongoing and widespread problem. While it is accepted that the objective of International Financial Reporting Standards (IFRS) is to provide investors with relevant information AAT is concerned that their requirements for detail may actually dilute the relevance of the information being produced (last para on page 37, condoc).

3.5. Conversely, some boards are reluctant to remove immaterial disclosures, often in the belief that in so doing they will be in contravention of the requirements of an IFRS (3.6, condoc).

3.6. Certain areas have been identified by investors as key focus points which are also the areas in which corporate reporting needs to be improved upon (3.2, condoc). The table

[1] Page 16 of **Corporate Reporting Review: Annual Report 2014**

outlining areas of investor focus (page 12, condoc) analyses what investors have said in the area and contrasted their comments with what the FRC's own findings.

3.7. The FRC's findings generally indicate omissions in the application of an IFRS or legislative requirement (for example a failure to identify the principal risks and uncertainties facing the company and no description of the actions taken to mitigate their effects) and misunderstandings of requirements resulting in errors or non-compliance with an IFRS/legislative requirement (for example in the preparation of the cash flow statement).

3.8. It is widely understood that IFRS are principles-based standards and as a consequence the application of professional judgement is required in some key areas, such as financial instruments and revenue recognition. AAT is concerned that the principles-based nature of IFRS can sometimes give rise to an inherent misunderstanding of what exactly is needed in the annual report (for example, the situations in which a company should separately report an accounting judgement or estimate).

3.9. In addition, the FRC cite significant accounting policies suffering from boiler-plating (condoc page 14 "*Accounting policies", in particular revenue recognition and capitalisation policies*). This, again, suggests that some of the requirements in IFRS (for example IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*) can sometimes be generally misunderstood by both accountants and auditors. Accountants and auditors understand that the annual report should disclose <u>significant</u> accounting policies; but it is evident from the FRC's findings that the content (or lack) of such policies is the issue (for example where a company does not identify <u>when</u> revenue is recognised).

3.10. AAT accepts that many smaller listed and AIM quoted companies are reluctant to reduce the level of disclosures in the annual report in case any issues arise with professional regulators, such as the FRC's Corporate Reporting Review Panel.

3.11. Taking into account 3.10 (above) AAT agrees that many preparers will often therefore include immaterial disclosures in the annual report for fear of being questioned by the regulators (3.3.3, page 17, condoc).

3.12. This is in contrast to the comments made in paragraph 3.5 (above) where companies fail to make adequate disclosure of accounting policies or other narrative disclosures. The underlying issue with regards to disclosures is, therefore, trying to strike a balance between what is needed to be disclosed in the annual report and what can be removed on the grounds of immateriality. Accountants and auditors may well benefit from additional application guidance within IFRS or other material to help them in getting the required disclosures correct as this will help them interpret exactly what is needed from a disclosure point of view.

3.13. AAT strongly disagrees with the cited auditor's statement *"It is too easy for accountants to tick off CPD requirements without getting appropriate training and technical updates"* (para 2, page 18, condoc). Professional accountants have a duty to ensure they undertake CPD which will enable them to maintain their level of competence and professional bodies have measures in place to monitor members' CPD for the purposes of both adequacy and relevance. Moreover many bodies are committed to an output based scheme which focusses on the quality and relevance of learning activities in meeting the members' learning and development needs as opposed to the quantity of hours of training and development undertaken.

3.14. AAT does not consider that CPD, in and of itself, is responsible for accountants' misunderstanding of the requirements of IFRS or other applicable legislation (See also 3.16, below).

3.15. AAT believes that the problem lies with the interpretation of the principles-based requirements of IFRS. Especially when it is combined with complex legislation.

3.16. The above situation (3.14 and 3.15) is then further compounded through the reliance placed by professional accountants on automated accounts production software systems, word-processing or spreadsheet packages to prepare financial statements for smaller listed and AIM quoted companies. In such instances some accountants may not challenge the generic content of software-produced disclosures, or misunderstand some of the requirements of an IFRS (see 3.8 and 3.9, above) or just boilerplate disclosures (3.3, above). This, in particular, is an area where AAT believes that accountants involved in the preparation of annual reports for smaller listed and AIM quoted companies might benefit from additional application guidance where IFRS and other reporting requirements are concerned (see also 3.12, above).

3.17. In the case of smaller-listed and AIM-quoted companies, AAT is of the view that audit firms should be permitted the opportunity to become more involved in the preparation of the annual report so as to offer technical input into areas where boards often struggle.

3.18. Only full listed companies are defined as a 'public interest entity' under the Audit Directive and Regulation and hence there may be an opportunity to reduce the burden on smaller-listed and AIM-quoted companies by restricting the provisions of the Ethical Standards to public interest entities only. This would also have the added advantage of being viewed as de-regulatory and would potentially help improve the quality of financial reporting for smaller listed and AIM quoted companies.

3.19. AAT believes that the impact of this concession would be twofold:

3.19.1. Firstly it would reduce the scope for poor quality reporting as the auditors would be able to identify inconsistencies or omissions earlier in the preparation stage;

3.19.2. Secondly it would reduce the amount of time pressure faced by auditors as smaller listed and AIM quoted companies would be encouraged to produce their annual reports much earlier than they currently do.

3.20. The FRC have identified time pressure to be a particular problem (3.3.1,condoc) thus allowing audit firms to have more involvement (provided adequate safeguards can be implemented by the audit firm) would serve to help in this respect.

3.21. The FRC have concluded that tightening audit practice and procedures in a number of areas would increase the effectiveness of audit (page 20, condoc). AAT agrees that the steps proposed by the FRC on page 20 (condoc) would serve to increase the effectiveness. However as observed in 3.19 (above) time is of the essence and the FRC have acknowledged that audit firms have suffered time pressure with audit reviews being conducted very close to the completion deadline (page 19, condoc). The audit process has to be completed in accordance with International Standards on Auditing (UK and Ireland) requirements and AAT agrees that auditors should consider deferring their opinion if they have insufficient time to conduct the audit to an appropriate standard.

3.22. In addition, auditors may feel under pressure (thus creating an intimidation threat) to complete the audit in a short timescale so as to avoid missing the deadline for filing the financial statements with the listing authority as this would result in the listing being suspended which would have commercial effects. However, boards should be encouraged to start the annual reporting process sooner rather than later after the reporting date has passed and where difficulties are encountered by the directors, then auditors should have the opportunity of guiding boards appropriately as suggested in paragraph 3.9 (above).

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?

3.23. AAT agrees that in general corporate reporting is poorer for smaller quoted companies than is the case for their larger counterparts (para 6, Executive Summary, condoc) and is often due to a scarcer level of technical resources available in a smaller listed and AIM quoted company than the technical resources made available in a larger, fully listed, company.

3.24. AAT considers that the majority of the actions proposed in the condoc are proportionate to the issues identified. Although, as stated above AAT does not view FRC's opinion in respect of CPD requirements to be a major contributing factor to the problems identified (3.13 and 3.14, above).

3.25. In terms of the adequacy of the responses to the issues identified, AAT agrees with some of the measures proposed by the FRC (page 21, condoc). In particular, AAT agrees with the proposal to send out annual reminders setting out the key areas of interest to investors, common errors and suggestions for improvements.

3.26. AAT considers that such an approach would help to focus boards' attention on key aspects and aid them in ensuring that their entities annual report provides relevant and reliable information to investors.

3.27. AAT does not believe that roundtable discussions with investors and smaller quoted companies (para 3 on page 21, condoc) is necessarily a useful proposal. Smaller listed and AIM quoted companies generally have a lesser number of investors in comparison to their larger counterparts and for this reason such an approach may not prove to be beneficial as many smaller AIM quoted companies are substantially owned by directors and/management.

3.28. Creating additional pressure on investors and rating agencies to provide more feedback on an entity's annual report may also not prove to be useful (para 3 on page 21, condoc). While most investors will focus their attention on key areas (such as principal risks and uncertainties and gaining an understanding of the underlying financial performance of the company) some may provide feedback which may be viewed as counter-intuitive. 'It should be noted that investors are not homogenous and not all investors are institutional investors. Investors and other stakeholders (such as rating agencies) have a whole range of needs in respect of the information that they wish to glean from an entity's annual report and some may provide feedback which could result in further non-compliance with IFRS/legislative requirements.

3.29. In addition, AAT does not believe that rating agencies are best placed to provide feedback on annual reports as rating agencies staff are not necessarily trained in IFRS and disclosures and this again could create additional reporting difficulties for smaller quoted companies where the information needs of rating agencies may be in conflict with the company's requirement to maintain compliance with the IFRS and disclosures.

3.30. AAT supports the proposal to encourage more participation in the practical work of the Financial Reporting Lab (last para, page 7, condoc). It is highly likely that smaller listed and AIM quoted companies would benefit from such participation because the Financial Reporting Lab will help such companies benefit from investor feedback and suggestions which have been tested and hence would enable boards to understand what investors need and how such information should be conveyed in the annual report.

3.31. As previously observed (3.13 and, 3.14. above) AAT does not consider that the current approach to CPD, in and of itself, is a cause of poor quality corporate reporting for smaller listed and AIM quoted companies and hence does not support the proposals on page 21 document (condoc under the 'Resourcing' heading).

3.32. Accountants regulated by a professional body are expected to comply with CPD requirements and this is verified by the professional body through compliance visits and other means.

3.33. A range of CPD activities can be undertaken by the accountant provided such activities are relevant to their role within the organisation. CPD is individual-specific and often supported by professional bodies who generally provide a wide range of activities from the provision of face-to-face seminars, e-learning activities, technical articles and online webinars.

3.34. The overarching objective of CPD is to support finance staff in keeping up to date with reporting requirements. AAT considers it to be more beneficial to provide additional application-guidance in conjunction with IFRS/legislative requirements. Such an approach would help boards through the provision of further guidance in respect of disclosures that are technically compliant, relevant and meet the needs of the users of the annual report.

3.35. As set out in 3.9 (above), it is often a misunderstanding of the principles embedded within IFRS/legislation that result in boiler-plate disclosure. This problem is compounded by the reluctance of boards to remove immaterial disclosures for fear of challenge by the FRC or other professional regulators and hence a focus on subjective issues such as materiality in narrative reporting might be more useful than challenging CPD requirements or the engagement partner approval process with the professional bodies.

4. Conclusion

4.1. AAT agrees that the quality of corporate reporting for larger, fully listed, companies is higher than smaller listed and AIM quoted companies as quoted companies at the smaller end of the scale usually have a smaller pool of technical resources (3.23, above) available to them. This will often result in boiler-plate disclosures being made within the annual report (3.35, above).

4.2. In addition, boards will often include immaterial matters within the disclosure notes in the belief that not doing so will result in criticism from the FRC and/or other regulators (3.5, above).

4.3. The application of professional judgement in the area of materiality needs to be addressed because boards of smaller quoted companies often struggle in applying judgement where materiality is concerned; particularly with narrative disclosures (3.8, above).

4.4. AAT agrees that the proposals in the condoc to address the issue of poor corporate reporting are largely appropriate and proportionate (3.24, above). However AAT does not agree on the proposal for more rigorous training and experience thresholds for audit engagement partners undertaking quoted company audits (bullet 3, page 20, condoc).

4.5. AAT considers that allowing auditors of smaller listed and AIM quoted companies the opportunity of more input into the financial statement process would be viewed by auditors and directors as de-regulatory given that only full listed companies are classed as public interest entities under the Audit Directive.

4.6. AAT does not agree that accountants fail to get appropriate training and technical updates as the CPD requirements imposed on members by their professional bodies will mandate them to either obtain a minimum amount of verifiable CPD (3.13-3.14, above) or obtain sufficient CPD to maintain professional competence in their area of work. .

4.7. AAT considers that the main issue giving rise to poor quality corporate reporting by smaller quoted companies is a misunderstanding of the IFRS principles and other legislative requirements (3.14, above).

4.8. To address the issue set out in 3.13, above, AAT recommends that consideration be given to the design and provision of more application-guidance to boards (3.34, above).

4.9. In addition and in support of the application-guidance annual reminders could also be designed to cover the key areas of focus for investors, common errors and suggestions for improvements (3.25, above). AAT would also agree with the FRC's suggestion of encouraging smaller listed and AIM companies to participate in the practical work of the Financial Reporting Lab to improve the quality of financial reporting.

5. About AAT

5.1. AAT is a professional accountancy body with over 49,300 full and fellow members[2] and 76,500 student and affiliate members worldwide. Of the full and fellow members, there are over 4,100 Members in Practice who provide accountancy and taxation services to individuals, not-for-profit organisations and the full range of business types.

5.2. AAT is a registered charity whose objectives are to advance public education and promote the study of the practice, theory and techniques of accountancy and the prevention of crime and promotion of the sound administration of the law.

6. Further information

If you have any questions or would like to discuss any of the points in more detail then please contact AAT at:

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[2] Figures correct as at 31 June 2015