

Dear Finance Director

The FRC is responsible for promoting high quality corporate reporting in the UK. To do so we set standards and also review the quality of reporting through the work of our Corporate Reporting Review team. In June we reported¹ on what investors told us they valued in the annual report and accounts of smaller listed companies such as yours. In the spirit of promoting continuous improvement I am writing to outline what we heard. Investors stressed that good quality reporting by smaller companies was of considerable importance to them. They noted, in particular, that they relied on the annual report as other sources of information such as analysts' reports were relatively scarce. They value high quality reporting that is company-specific and avoids the use of generic or "boilerplate" information; communicating a meaningful picture of the business to enable them to make investment decisions. In particular they expect:

- the Strategic Report to be, clear, concise, balanced and understandable;
- accounting policies to be clear and specific, particularly in relation to revenue recognition and expenditure capitalisation; and
- a clear explanation of how the company generates cash flow.

Strategic Report

The Strategic Report Regulations require companies to explain their business model and strategy clearly and to set out how they manage the principal risks and uncertainties facing the business. In preparing the strategic report the company should ensure:

1. It sets out a clear narrative, including:
 - a clear description of the company's business model and strategy²;
 - the main trends and factors likely to affect the future development, performance or position of the business; and
 - linkages between information presented within the strategic report and in the annual report more broadly. For example, are descriptions of different revenue generating activities consistent with the business segments disclosed in the financial statements?
2. It includes the principal risks and uncertainties that are material to the development, performance, position or future prospects of the company that are regularly monitored by the Board; not a long list of generic risks. It should also explain why they are material and how they are managed or mitigated;
3. The financial and non-financial key performance indicators are consistent with other financial information presented in the annual report; and

¹ Section 3.2 of the FRC's publication "Improving the Quality of Reporting by Smaller Listed and AIM quoted companies" which can be found at <https://www.frc.org.uk/Our-Work/Publications/FRC-Board/Consultation-Improving-the-Quality-of-Reporting-b-File.pdf>

² Best practice would be to include some information on business model and strategy as it would be difficult to understand the strategic report without it. It is, however, only required for quoted companies, not AIM.

4. The analysis of the development and performance of the business in the report is balanced and comprehensive. Does the report provide sufficient explanation of the results, cash flows and balance sheet movements and trends?

The FRC issued Guidance on the Strategic Report in June 2014. A copy can be found at:

<https://www.frc.org.uk/Our-Work/Codes-Standards/Accounting-and-Reporting-Policy/Clear-and-Concise-Reporting/Guidance-on-the-Strategic-Report.aspx>

This sets out the requirements and best practice for different types of company, including AIM and smaller listed companies.

Accounting policies, significant judgements and estimates

Investors pay particular attention to policies that appear unusually aggressive or out of line with similar companies in the industry. They also seek to understand the more judgmental areas of the financial statements (where management estimation and judgment has been applied). In preparing its accounting policies, the company should therefore consider the following questions:

1. Are accounting policies described for all significant transactions and revenue streams, including all those described in the Strategic Report, and those that are material to the financial statements?
2. Is it clear from the revenue recognition policy, the points at which revenue is recognised for each revenue stream?
3. Are the accounting policies specific and relevant to the company rather than merely copied from accounting standards or model accounts? Are insignificant policies excluded?
4. Are there clear policies for the capitalisation of assets and is it clear how the criteria for capitalisation are met?
5. Have all of the significant judgements or estimates been separately reported with a clear description of how management has made its judgement or estimate?

For practical ideas on what investors like to see in accounting policy and estimates disclosure read this Financial Reporting Lab report:

<https://frc.org.uk/Our-Work/Publications/Financial-Reporting-Lab/Accounting-policies-and-integration-of-related-fin.aspx>

Cash flow statements

Investors seek to understand how a company converts its profits into cash and its liquidity. They are concerned that the cash flow statement is sometimes left to the last minute and can be incorrect. A company should ensure it has given adequate time to considering whether the classification of operating, investing and financing cash flows is consistent with the business model described in the Strategic Report; whether attention has been paid to the classification under accounting standards of unusual or non-recurring cash flows which may nonetheless meet the definition of operating cash flows; and whether late adjustments have been reflected in the cash flow statement.

Technical findings of the Financial Reporting Review Panel

The FRC would also like to draw your attention to the technical findings of the Financial Reporting Review Panel 2015-2016 which can be found at:

<https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2015/October/FRC-publishes-Corporate-Reporting-Review-Annual-Report.aspx>

This provides further detail on the above areas as well as highlighting other common areas of enquiries from our reviews of annual reports.

I hope that you find this letter helpful and would be happy to answer any questions. Replies should be sent to Anna Colban (a.colban@frc.org.uk).



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