Consultation Update

Financial Reporting Council

June 2016

Update on the discussion paper: Improving the Quality of Reporting by Smaller Listed and AIM Quoted Companies

The FRC is responsible for promoting high quality corporate governance and reporting to foster investment. We set the UK Corporate Governance and Stewardship Codes as well as UK standards for accounting, auditing and actuarial work. We represent UK interests in international standard-setting. We also monitor and take action to promote the quality of corporate reporting and auditing. We operate independent disciplinary arrangements for accountants and actuaries, and oversee the regulatory activities of the accountancy and actuarial professional bodies.

The Financial Reporting Council Limited is a company limited by guarantee.
Registered in England number 2486368. Registered Office:
8th Floor, 125 London Wall, London EC2Y 5AS

Contents

1 Introduction

Background

The FRC is responsible for promoting high quality corporate governance and reporting to foster investment. We set the UK Corporate Governance and Stewardship Codes as well as UK standards for accounting, auditing and actuarial work. We represent UK interests in international standard-setting. We also monitor the quality of corporate reporting and auditing, taking action where necessary. We operate independent disciplinary arrangements for accountants and actuaries; and oversee the regulatory activities of the accountancy and actuarial professional bodies.

In June 2015 the FRC published a discussion paper: *Improving the Quality of Reporting by Smaller Listed and AIM Quoted Companies*[1]. The purpose of the discussion paper was to set out the FRC's view of the underlying reasons for poorer quality reporting by some smaller listed and AIM quoted companies and to put forward a range of proposals designed to help them improve the quality of their reporting.

The paper highlighted the importance of high quality reporting to investors in smaller quoted companies. In a segment of the market where liquidity and access to capital is more limited, high quality reporting can differentiate companies, resulting in an increased likelihood of investment. To help smaller companies achieve this the FRC set out a number of proposals to facilitate improvements in the quality of reporting.

This document provides an overview of the feedback to the discussion paper and an update on decisions and progress against the proposals in the three key areas: reporting requirements and practices, audit practices and company governance and resources.

1 https://www.frc.org.uk/Our-Work/Publications/FRC-Board/Consultation-Improving-the-Quality-of-Reporting-b.aspx

2 Feedback and FRC response

Introduction

The discussion paper invited views on whether:

- commentators recognised and agreed with the issues raised in the report regarding the quality of reporting by smaller quoted companies?

- the actions proposed were (i) a proportionate response to the issues identified; and (ii) an adequate response to the issues identified?

We received a total of 23 responses to the discussion paper, none of which were confidential. These came from 8 audit and accountancy firms; 6 professional accountancy bodies; the Quoted Companies' Alliance representing smaller listed and AIM companies; 5 investors (incl. investor representative bodies); and 3 smaller company directors.

Respondents:

- were generally supportive of the findings and proposed actions;
- urged regulators to avoid imposing additional regulatory burdens on smaller quoted companies, particularly AIM companies;
- agreed there should be a common reporting framework for all quoted companies and supported the use of IFRS as the most appropriate framework;
- did not support a review of the Responsible Individual registration process;
- welcomed the proposal to issue annual reminder letters targeted at smaller quoted companies;
- agreed that the FRC should encourage more participation in Financial Reporting Lab initiatives by smaller quoted companies;
- supported the intention to develop further practical guidance for audit committees on evaluating the quality of the financial reporting function and process; and
- welcomed the initiative to explore opportunities for providing more focussed and practical support for preparers through training and CPD regimes.

Overview of responses

Reporting requirements and practices

We proposed:

In relation to the reporting requirements the FRC proposed it would:

- provide focused annual reminders to boards of smaller quoted companies setting out the key areas of focus for investors, common errors that we encounter in annual reports and suggestions for improvements in these areas;

- include specific consideration of smaller quoted companies in its Clear & Concise reporting initiative;

- encourage more participation by smaller quoted companies and their investment community in the practical work of the FRC's Financial Reporting Lab to identify ways to improve the quality of corporate reporting. Such participation would:

  - help to ensure that corporate reporting better meets the needs of both; and
  - explore additional methods of sharing with smaller companies the innovative suggestions developed in the Lab that are tested with investors, so they can be put into practice;

  and

- consider whether the Capital Markets Union (CMU) provides an opportunity to develop a differentiated disclosure framework for smaller quoted companies, building on the IFRS-based approach adopted in UK GAAP. The FRC has already highlighted this in its recent response to the CMU green paper at https://www.frc.org.uk/Our-Work/Response-to-external-consultations/Responses-2015.aspx;

Feedback:

There was broad-based support from auditors, professional bodies and investors for the FRC issuing annual reminder letters targeted at smaller quoted companies as a means to encourage engagement and improve knowledge. This was considered by many respondents to be a useful way in which the FRC could highlight investor views on reporting to companies.

There was some agreement that users of annual reports need to be more vocal and to challenge companies more. A minority of respondents queried how practical it was for the FRC to put pressure on investors to give more feedback. One respondent suggested the Investors Forum, rather than the FRC, should play a greater role in creating pressure on investors to engage more. A number of respondents urged caution in putting pressure on investors. Several respondents pointed out that smaller quoted companies were often majority owned by directors and management and suggested greater dialogue with investors would be of limited significance. This may be true; nevertheless dialogue is important for the protection of minority shareholders.

There was overall support from all stakeholders for greater participation by smaller quoted companies in the Financial Reporting Lab. It was pointed out that Lab reports are useful practice aids for audit committees and boards and can encourage improvements in quality, and that there is scope for more innovation in smaller company reporting. Respondents recognised, however, that it may be difficult to persuade smaller quoted companies to take part due to resource constraints and concerns about public scrutiny.

Respondents supported, almost unanimously, the finding that there should be a single accounting framework for all quoted companies as it provides consistency and comparability. The overwhelming majority of respondents agreed that IFRS is the right framework for all quoted company reporting. Investors gave clear support for this but recognised that there could be merit in the FRC engaging with BIS and the Listing Authorities to explore ways size might be taken into account to deliver improved reporting.

There was a minority view that the requirements for detail in IFRS may dilute the relevance of the information being produced. One respondent felt that AIM companies should be permitted to prepare accounts in accordance with UK GAAP.

There was general consensus that too much disclosure is required and a sense that some disclosure requirements are disproportionate to the benefit that is likely to be obtained. There were mixed views about whether a differentiated disclosure framework for smaller quoted companies is an appropriate solution. Some respondents felt there was merit in the idea of considering whether the needs of users of smaller quoted company financial statements were different and could justify developing a unique framework, similar to FRS 101, for AIM companies. However, the balance of views was against developing a separate disclosure framework or an IFRS-lite regime for smaller quoted companies.

There were concerns that a reduced disclosure framework would lower the quality bar and could lead to smaller quoted companies not being required to disclose material items. Many of those who responded felt that the way forward lay in encouraging more radical thinking by the IASB in its disclosure project to make IFRS disclosures proportionate for all companies.

Many respondents agreed that boiler-plate disclosures clutter the financial statements of a significant proportion of companies, large and small. One respondent suggested that boiler-plate was provided because companies did not want to disclose commercially sensitive information.

One respondent commented that CRR and AQR seldom raise over-disclosure or suggest disclosure need not be given. They suggested that the FRC could do more to highlight over-disclosure and counter any perception that disclosure of immaterial information is expected, and encourage more challenge from audit committees on decluttering.

A number of respondents felt that auditors could be encouraged to take a more robust line on materiality and tighten disclosure checklists. Companies were often reluctant to remove disclosures for fear of falling foul of the FRC's CRR; auditors could make a difference by encouraging them to be bolder.

On alternative performance measures (APMs), one respondent suggested investors could do more to challenge companies on their use of APMs and that the FRC could provide examples of what good looks like. We have recently issued some Frequently Asked Questions on this topic which can be found here https://www.frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/FAQs-ESMA-Guidelines-on-Alternative-Performance-M.pdf

In relation to AIM, overall respondents agreed that stock exchanges have a role to play in promoting high quality reporting and encouraged the FRC to engage further with the AIM market. Views were divided about whether the reporting period for AIM companies should be brought into line with the main market. There was some support for encouraging AIM companies to adopt voluntarily the extended auditor report, particularly from investors.

FRC's response:

We issued our first annual reminder for smaller quoted companies in November 2015 https://www.frc.org.uk/Our-Work/Publications/FRC-Board/FRC-Letter-Year-end-advice-to-preparers-smaller.pdf . It focussed on those areas where the FRC has found there is room for improvement and which investors highlight as areas of importance to them. The letter was well received and auditors report that it has been a useful tool for focussing their discussions with audit clients. We will continue to monitor the quality of reporting by smaller quoted companies and will identify any improvements in key areas.

The Financial Reporting Lab reports it has seen increased interest from smaller companies in participating in Lab projects over the last year. A number of AIM companies are currently taking part in the Business Model project which provides direct feedback to companies by investors.

The UK Stewardship Code sets out the principles of effective stewardship by investors and so assists them better to exercise their stewardship responsibilities. Signatories are required to publish an annual statement against the seven principles of the Stewardship Code. The FRC is currently assessing all signatory statements with a view to tiering them in terms of quality, and making this assessment public. This process is designed to improve the quality of reporting against the Stewardship Code, bring greater transparency to asset owners and clients, and maintain the credibility of the Stewardship Code. In achieving these objectives, investors are encouraged – as part of their stewardship responsibilities – to engage with companies where they consider reporting should be improved. This will also assist in improving overall market transparency.

We believe these are the most effective ways in which the FRC can encourage greater engagement by investors and improved awareness by companies of investor priorities.

We will explore whether there are opportunities through our Financial Reporting Lab for further work to address companies' reluctance to tighten their approach to disclosures.

Audit practices

We proposed:

In relation to the audits of smaller listed and AIM quoted companies we proposed the FRC:

- would review whether the process of granting of Responsible Individual status could be improved to ensure that audit partners are suitably qualified and experienced to carry out audits of smaller quoted companies.
- would consider, as part of its 2015 review of the ethical standards, providing greater clarity for auditors and audit committees on what is acceptable support and what is not.
- would carry out a thematic study on the Engagement Quality Control Review (EQCR) role during 2015. A further study will be carried out on audit firms' internal quality control procedures.

Feedback:

Respondents did not support the proposal to review whether the process of granting Recognised Individual (RI) status could be improved to ensure that audit partners are suitably qualified and experienced to carry out the audits of listed or AIM quoted companies. Audit firms and professional bodies felt that there was a lack of evidence to support a need for a separate registration for RIs auditing listed companies and that the audit firms should be trusted to decide whether an RI had suitable qualifications and experience. Investors felt there was merit in consulting the professional bodies to see if the existing process could be improved.

Respondents were virtually unanimous in welcoming the proposal for the FRC to consider whether there was a need for more clarity around the boundaries of how far auditors can go to assist smaller quoted companies with financial reporting issues while maintaining an appropriate level of independence.

Smaller audit firms and professional bodies expressed the view that the ethical standards were too restrictive and there was an opportunity to relax the ethical requirements in a way that did not jeopardise independence for entities which do not meet the EU definition of a public interest entity (PIE) and/or are quoted on the AIM market.

One of the professional bodies felt that the rules about which services can be provided are already clear. It suggested the constraints on the ability of auditors to influence the overall quality of financial statements deserved more emphasis and recognition. Where companies leave production of the financial statements until late in the cycle, the auditor's suggestions can be received too late to make a significant difference to quality, particularly where the mind-set of directors is to make the minimum changes necessary to secure an unqualified audit opinion.

FRC's response:

We have decided not to pursue the proposal to review the RI registration process as we believe this would impact smaller audit firms hardest and we want to be sure there is evidence of a significant problem before we proceed. However, it is important that RIs have sufficient levels of expertise and experience to deal with the audits of listed entities. We will continue to monitor this through our audit quality reviews; should we find evidence to suggest a significant problem with RI competence in the course of these reviews we will seek a discussion with the professional bodies.

Our consultation issued in September 2015 on proposed revisions to the ethical standard for auditors included proposals for reliefs from the independence requirements in the ethical standard for auditors of companies on the AIM market with a market capitalisation of £100 million or less. Following the consultation it has been decided that the reliefs should apply for companies with a market capitalisation of 200 million euros or less (in common with the MiFID II Directive). The revised ethical standard has been issued and provides some flexibility to auditors in giving advice to smaller quoted companies on financial reporting matters where the law allows.

In February 2016 we published a thematic study on the Engagement Quality Control ("EQC") review process https://www.frc.org.uk/Our-Work/Publications/Audit-Quality-Review/Audit-Quality-Thematic-Review-7/9_Engagement-Quality.pdf . The EQC review process should ensure consistently high quality. Often it does improve quality but we also found evidence in some audits where weaknesses were not identified by the review. Firms can do more to ensure that EQC reviewers have a level of technical expertise that is commensurate with that of the Responsible Individual signing the audit opinion, evaluate the timeliness and effectiveness of the EQC review and implement additional procedures, where appropriate, to reduce the occurrence of audit weaknesses that are not identified.

We also published a thematic study on audit firms internal quality monitoring processes https://frc.org.uk/Our-Work/Publications/Audit-Quality-Review/Audit-Quality-Thematic-

Review-Firms-audit-qualit.pdf. This noted that firms should do more to assess whether individuals involved in the firm's quality control processes, in addition to the audit partner, ought to have identified any issues arising on the audit and corrected them prior to the audit opinion being signed.

Company governance and resources

We proposed:

To address the root cause of insufficient skilled resourcing in smaller quoted companies' financial reporting functions we proposed the FRC would:

- discuss with the accountancy and audit Professional Bodies (ICAEW, ACCA, ICAS, CAI) and others, ways of providing more focussed training to finance staff to fulfil continuous professional development (CPD) requirements;
- discuss with the London Stock Exchange and UK Listing Authority ways to ensure that boards understand the importance of, and have adequate financial reporting resources to meet, their ongoing reporting obligations and encourage them to consider educational initiatives to assist directors in their reporting responsibilities; and
- develop practical guidance for audit committees and boards on evaluating the adequacy of a company's financial reporting function and process.

Feedback:

There was general caution against imposing additional compliance burdens on smaller quoted companies, e.g. through a mandatory corporate governance code for AIM companies, or further regulatory obligations with regard to the composition of the audit committee, and a view that encouraging best practice was the better way forward.

There was limited support from respondents for developing some corporate governance principles for smaller quoted companies and for further consideration of the issues related to the skills, experience and quality of directors on smaller quoted company boards, particularly financial reporting experience.

Some respondents felt the FRC should encourage companies to ensure the roles of company secretary and finance director are separate and that qualified individuals prepare the financial statements.

On education and training there was considerable support for the proposed actions and agreement that there is scope for providing more focussed and more practical assistance to smaller preparers and for harnessing the CPD regime, which plays an important role in ensuring finance teams are technically able and up-to-date, to provide more support to finance staff.

One respondent suggested that there would be merit in reviewing whether examination and qualification requirements continue to focus sufficiently on financial reporting expertise.

There was considerable appetite for practical guidance for audit committees on evaluating the adequacy of the finance function and process. There was also support for the view that the tone taken by the board and audit committee with respect to corporate reporting is an important driver of quality.

FRC's response:

We held a roundtable discussion with nine professional accountancy bodies to explore ways to provide more focussed and practical training to finance staff.

In 2016/17 we will:

- continue to work with the professional bodies to find ways to provide more focussed and practical training to finance staff;

- engage further with the London Stock Exchange and UK Listing Authority to identify opportunities for encouraging improvements in the quality of reporting; and

- establish a working group to develop practical guidance to audit committees on evaluating the adequacy of the finance function and process.

Appendix: List of respondents to the June 2015 discussion paper

Professional bodies

ICAEW
CIMA
AIA
AAT
ICAS
South Western Society of Chartered Accountants

Preparer representatives

Quoted Companies Alliance

Audit and Accountancy firms

Mazars LLP
PwC LLP
Grant Thornton UK LLP
Moore Stephens LLP
MAH Chartered Accountants
BDO LLP
Baker Tilly LLP[2]
Deloitte LLP

Investors and Investor bodies

Standard Life Investments
Investment Association
UK Shareholders Association
Association of Investment Companies
Paul Roberts

Others

Ross Graham
David Lloyd
Western Selection plc

[2] Now RSM UK

Financial Reporting Council
8th Floor
125 London Wall
London
EC2Y 5AS

+44 (0)20 7492 2300

www.frc.org.uk