Consultation

Financial Reporting Council

June 2015

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

Discussion paper on the FRC’s findings and proposals

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.

Contents

Page

FOREWORD

By Stephen Haddrill, Chief Executive, the Financial Reporting Council

Smaller listed and AIM quoted companies ("smaller quoted companies") are important in generating future growth in the economy and need access to capital in order to invest and grow. The Organisation for Economic Co-operation and Development ("OECD") reports that it considers small and medium sized companies to be critical to ensuring that economic growth is sustainable and inclusive. The green paper, "Building a Capital Markets Union" issued by the European Commission in February 2015 suggests ways to unlock investment particularly for smaller entities, including through simpler reporting requirements.

UK and European companies rely heavily on banks to finance their expansion, compared to their counterparts in the United States. US companies receive around five times more funding from capital markets than those in the EU. Approximately 10 per cent of corporate liabilities in the US are loans whereas the figure for the UK is nearer 25 per cent. It is important to encourage alternatives in the interests of growth, including equity placements via a public listing.

We recognise, however, that the process and costs of listing can be a challenge for smaller companies, and that the ongoing requirements of being listed, such as reporting and transparency, create costs as well as providing a basis for investment decisions.

This important initiative has enabled the FRC to understand better the challenges faced by smaller quoted companies and to explore ways in which we might help them. Companies sometimes say that investors are not interested in their annual reports and therefore they do not prioritise producing high quality documents. In fact, our evidence shows that the annual report in this market segment is particularly important to investors in the absence of analysts' reports and that the quality of reporting can affect investment, rating and lending decisions. And it is in precisely the areas that matter most to investors that the FRC finds issues of poor quality reporting. Investors also rely on the quality of audits in this market segment; auditors can make an important contribution to raising reporting quality and the quality of governance, while still maintaining appropriate independence from management. There is clear opportunity for auditors to apply their knowledge and resources to make a real difference to the usefulness of these annual reports to investors.

The FRC is the UK's independent regulator for promoting high quality corporate governance and reporting to foster investment. It plays an important role in creating and maintaining an effective and proportionate governance and reporting framework within which quoted companies can thrive and which gives confidence to investors.

We hope this report is an important and timely intervention which we hope will raise awareness of the challenges faced by smaller quoted companies and facilitate a more coherent and co-ordinated response. Companies, investors, auditors and regulators all have a role to play in driving improvements in the quality of reporting and to improve the potential to access capital.

This report sets out how we think each of us can contribute and shares the FRC's ideas for how it might help.

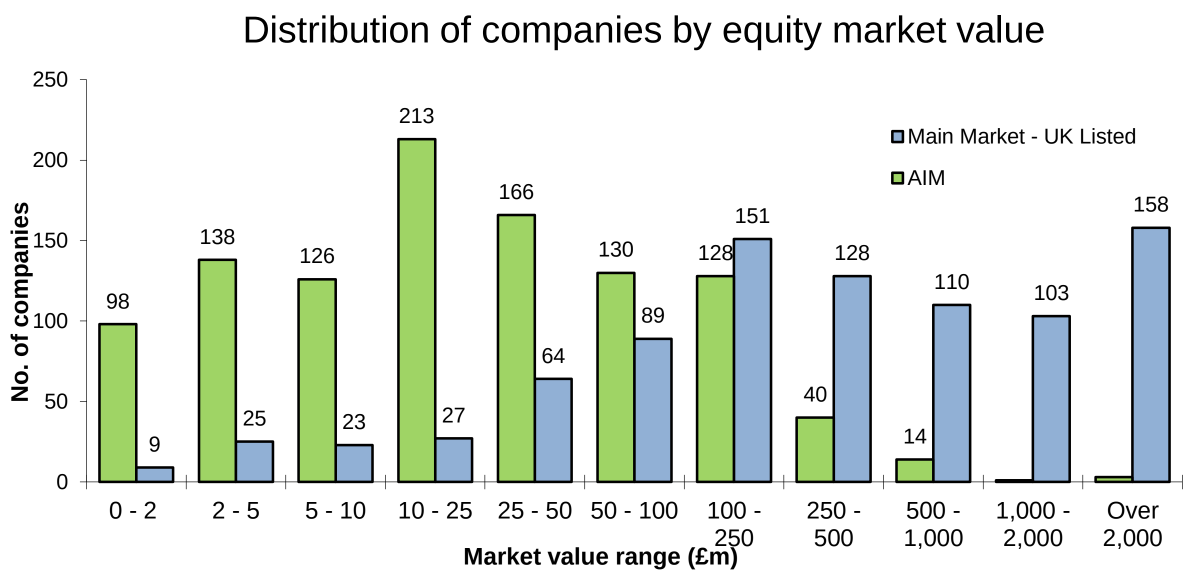
We are looking for feedback on the findings and conclusions we have reached.

1 Introduction

The FRC's view is that clear and concise, high quality reporting by smaller quoted companies will facilitate investment in them. Yet over a period of time the FRC has found that, whilst the system of reporting is not fundamentally flawed, the quality of reporting is lower by such companies than by larger listed companies. In 2014, the FRC initiated a project looking at whether the quality of reporting matters to investors in smaller quoted companies and, if so, how to support companies to improve the quality of their reporting. The first phase of the project involved gathering and assessing evidence of the issues and challenges in order to gain a better understanding of the barriers to higher quality reporting and exploring ways in which the FRC can support such companies to help them improve their reporting and increase their attractiveness to investors. This report sets out the findings from this first phase.

During the course of this project we focussed our considerations on listed companies with a market capitalisation between £20m and £100m and UK companies quoted on the Alternative Investment Market[1] ("AIM") with a market capitalisation of greater than £5m.

The chart below (*source: London Stock Exchange Group plc*) demonstrates the contrast in size of companies by market value between the AIM and main market in the UK:



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1 AIM is not subject to the UK Listing Authority listing rules. Companies must comply with the AIM Rules of the London Stock Exchange which include certain mandatory reporting requirements including the use of IFRS. Companies quoted on AIM are not required to follow the UK Corporate Governance Code. However, the AIM Rules require companies to provide details of the corporate governance code that the company has chosen to apply. If no code has been adopted this fact should be stated together with a description of its corporate governance arrangements. AIM companies are required to file their annual report within six months of the year end.

Our evidence gathering has consisted of five strands of work (the results of which are set out in Appendices 1–5 of this report):

(i) Discussions with a wide range of stakeholders (including fund managers who invest in such companies, other users of the annual report and those involved in their preparation, review and audit) to identify their key concerns relating to the quality of reporting in this market segment. We have also surveyed those involved in the preparation of annual reports and private investors.
(ii) The identification of common themes arising from the FRC's Corporate Reporting Review ("CRR") team's reviews of the annual reports of smaller quoted companies.
(iii) The FRC's Audit Quality Review ("AQR") team's review of audit firms' processes for the review of smaller quoted companies' financial statements.
(iv) Consideration of the corporate governance arrangements at a sample of smaller quoted companies.
(v) Research into the extent of knowledge and qualifications of the individuals responsible for preparing and/or approving annual reports.

We would like to thank those who have contributed to our review to date and we are interested in views of as many users and preparers of annual reports as possible so invite feedback on the findings and proposals set out in the report. Interested parties are invited to send feedback to p.fitz-gerald@frc.org.uk or a.colban@frc.org.uk by **31 July 2015**. We welcome any comments on the report but we would be particularly interested in responses to the following questions:

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?

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?

2 Executive Summary

Investors report that good quality corporate reporting is an important factor in making investment decisions. There is a legitimate expectation amongst users that the annual report provides trustworthy information and it is therefore an important tool for holding companies to account.

The annual report has value for investors. It gives confirmation of what has previously been reported and is a source of information that is used for trend and performance analysis. Many also point out that the annual report is vital because of the degree of assurance it provides as a result of the work undertaken by the auditors and the scrutiny it receives at board level.

"Annual reports I think are really important. One of the things I really value about the annual report is that when it is published, it can't be changed. Why is that interesting? It's different from the internet which is updated all the time. People have to think quite seriously about what they put in their annual report because if they get it wrong, it's out there forever. So it absolutely means that hopefully, people took a great deal of thought to what they put in, and that for me as an investor is quite helpful." Gervais Williams, Miton Group plc.

The importance of the annual report to investors in this segment of the market is amplified by the falling level of analyst coverage and the absence of other reliable publicly available data. At the same time, recent changes that allow investments in AIM companies to be held in Individual Savings Accounts ("ISAs") coupled with the abolition of stamp duty on AIM investments, have elevated the public interest in good quality annual reports by these companies.

Those making or influencing lending decisions also pay particular attention to the detail in an annual report and the quality can affect their rating and lending decisions. Accordingly, high quality annual reports improve a company's access to capital and potentially reduce its cost of capital.

Overall, the quality of reporting by smaller quoted companies in the UK is generally regarded by investors and other users to be timely and of a good standard, but with room for improvement in a number of key areas. The FRC has found from its review of annual reports that, whilst the system of reporting is not fundamentally flawed, there is a higher incidence of poorer quality annual reports by smaller quoted companies than by their larger counterparts. Making improvements to the quality of reporting would provide better and more relevant information to investors and potentially open up greater access to capital for some companies.

Many smaller quoted companies think that investors do not read their annual reports and therefore that the reports are of little value. As a result the preparation of the annual report becomes a compliance exercise rather than being seen as an opportunity to provide relevant information to stakeholders.

Some smaller quoted companies find preparing their annual reports challenging. Sometimes they lack sufficient skilled resources and are not up to date with reporting requirements and standards. This is at a time when the company may itself be entering into more complex and transformational transactions. In addition, companies may have limited access to additional external reporting expertise.

Such factors can combine and contribute to a lack of focus, poor planning and insufficient time for adequate review and audit; as a result basic errors may creep in.

It is clear that despite the perceptions of many companies, the annual report really matters to investors, particularly for smaller quoted companies that have limited other opportunities to communicate with investors. An investor is more likely to invest if the annual report conveys a clear message of the business model of a company and its position and prospects, is prepared in accordance with clear and appropriate accounting policies and gives insight into these and other judgements, estimates and provisions. Yet it is in exactly these areas that the FRC finds issues of quality.

It is not just the finance function which can make a significant contribution to raising the bar on quality. Those charged with governance and auditors can make a real and substantial difference to the quality of annual reports by engaging more effectively in the reporting process. The FRC therefore proposes taking steps to encourage improvement in a number of areas, including those set out below; more detail can be found in section four of this report.

Reporting requirements and practices

The FRC has explored whether there is any appetite for allowing AIM quoted companies to report under UK GAAP as an alternative to IFRS. The overwhelming response from investors, auditors and companies indicates that, despite some perception that IFRS may be unnecessarily complex, it is right for all listed and quoted companies to report under a single accounting framework (for recognition and measurement) as it provides consistency and comparability.

However, preparers of annual reports and investors are both concerned with the volume of information contained in annual reports, some of which is of little interest to investors. One of the common findings of the FRC's reviews of annual reports is that too much of the disclosure is copied from a reporting standard or model set of financial statements with little attention to the company's specific circumstances (sometimes referred to as "boilerplate"). Use of boilerplate disclosure is of limited value to investors. Similarly disclosure of information that is not material to the financial statements can cause unnecessary length. Both are likely to deter investors. To encourage and assist in a more tailored approach by companies and regulators, the FRC will:

- 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;

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

- 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; and

- 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 small companies the innovative suggestions developed in the Lab that are tested with investors, so they can be put into practice.

Audit practices

One potential root cause of poorer quality annual reports raised in the project was whether auditor ethical standards inappropriately deny smaller quoted companies access to specialist skills and, if so, whether they should be amended to allow auditors of smaller quoted companies to have greater involvement in the preparation of all or part of the annual report. A majority of stakeholders told us they were comfortable with the current independence requirements for auditors. Although, the precise boundary is open to interpretation and we have found that many audit firms err on the side of caution for fear of being criticised by the FRC, the auditor ethical standards do allow auditors to provide management with accounting advice on matters that have come to their attention during the audit. Whilst there may be some need for clarification around that boundary, there was only limited support for any relaxation of the ethical standards for auditors.

The FRC will 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.

Our review of audits of smaller quoted companies identified areas for improvement which we have raised with the audit firms. These are set out in section 3.3.4 of this report. We have been encouraged by the positive responses that we have received from the firms detailing proposed changes to their processes and procedures and initiatives with their staff and their clients to raise awareness of the importance of good quality reporting in this sector of the market. We expect that these changes will help to have an impact on the quality of reporting as the auditors have an important role to play in making improvements.

We identified that in some firms the technical training and review requirements are less stringent than for larger listed companies. We will 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.

Reporting to those charged with governance also appears to be less rigorous than we observe elsewhere. The FRC recently published a practice aid for audit committees to assist in their evaluation of audit quality https://frc.org.uk/Our-Work/Publications/Audit-and-Assurance-Team/Audit-Quality-Practice-Aid-for-Audit-Committee-(1).pdf. This includes reference to the requirement of auditors to report on the effectiveness of a company's financial reporting process.

Company governance and resources

A lack of resources was the most frequently cited challenge for smaller quoted companies, both in terms of quantity and access to appropriately qualified resource. This places pressure on the company, particularly its finance function, and the auditors. In such circumstances engagement in the corporate reporting process by those charged with governance is all the more critical.

To address the root cause of insufficient skilled resourcing, we will:

- 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 CPD requirements;

- discuss with the London Stock Exchange and UK Listing Authority ways to ensure that companies 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 companies 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.

3 Findings

3.1 Benefits of good quality reporting by smaller quoted companies

The annual report is an important tool for communicating with investors. Yet there is a perception that they are not read by investors and therefore become an exercise in compliance rather than one which adds real value to the company. As a consequence, boards do not always allocate adequate resources to their preparation.

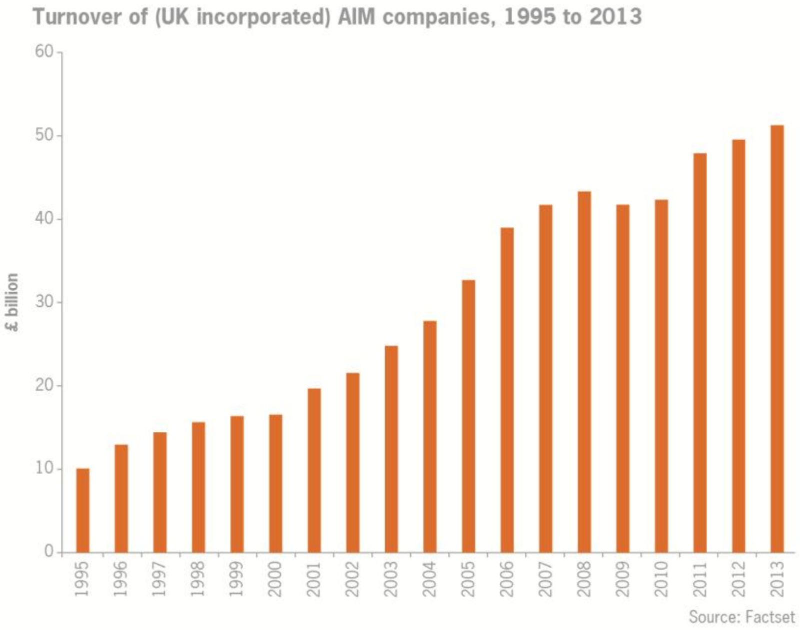
"We get very little direct feedback [from investors]. We get questions on the front half of the annual report, but very rarely on anything that is exclusively in the back half." Financial Director

Investors, by contrast, told us that good quality reporting is a key factor when evaluating investment decisions involving smaller quoted companies. For example, the annual report has real value for fund managers because they have confidence in the integrity of the report due to the work undertaken by the auditors and the scrutiny it receives at board level. Whilst not all fund managers read the reports in full, many rely on analysts' reports which use information in the annual report. Our survey of private investors indicated that 87% consider the annual report to be an important source of information for taking investment decisions (27% indicated that it was the primary source).

"Annual reports are an important source of information for investors. They provide us with a real understanding of a business and its drivers, its financial strength, and the quality of management. We look to the report to provide us with the building blocks on which we make our investment decisions. The quality of these reports really matters. My message to companies is that improving the quality of your reporting will make you more attractive to investors" Jessica Ground, Global Head of Stewardship, Schroders

Good quality reporting is more than merely a compliance exercise. Companies are more likely to attract investors and lenders if the quality of reporting is good, thereby improving a company's access to, and cost of, capital. Similarly the quality of a company's reporting has an impact on its credit rating. The quality of reporting is particularly important for companies in this market segment as typically there is less public information available on such companies and many of those we spoke to reported low and falling levels of analyst coverage.

The turnover of AIM companies has been rising steadily since the market first launched in 1995, making high quality reporting in this market increasingly important:



Whilst the FRC considers that it is important to ensure that the annual report as a whole is fair, balanced and understandable and of high quality, we have highlighted in this report areas where investors pay particular attention and encourage smaller quoted companies to prioritise improvements in these areas.

3.2 Areas of investor focus

Investors in this segment of the market told us that the areas that they focus on most in relation to smaller companies are as follows:

- Business model, principal risks and uncertainties.
- Cash flow statements.
- Understanding the underlying financial performance of the company.
- Disclosure of accounting judgements and estimates.
- Accounting policies, in particular revenue recognition and capitalisation policies.
- Provisions – both new provisions and those released during the year.

Yet these are areas where our reviews of annual reports identify the need for improvement. Many of these areas are an important focus for larger companies as well, however the incidence is higher for smaller quoted companies. The table overleaf illustrates what investors have told us in each of these areas and typical issues the FRC finds in its reviews.

Table: Areas of investor focus

	What Investors Say	FRC's Findings
Business model, principal risks and uncertainties	Investors informed us that the annual report is an opportunity for companies to explain their business model and strategy clearly and to set out how they identify and manage the principal risks and uncertainties facing the business which are required to be disclosed.	Business reviews, and subsequently, Strategic Reports, are not always balanced or comprehensive, as required, or appear to be inconsistent with other information in the annual report. Examples include: • Failure to identify the <u>principal</u> risks and uncertainties facing the company and no description of the actions taken to mitigate their effects; • Poor or limited explanation of performance or failure to identify components of growth or profit – for example: – that growth was due to acquisitions rather than organic expansion; – that the reported profit was wholly due to a change in amortisation rates; and • Limited reference to, or inadequate analysis of, significant or exceptional items disclosed in the annual report.
Cash flow statements	In this segment of the market, investors are particularly interested in a company's ability to generate cash. Fund managers agreed that the cash flow statement and the related disclosures and explanations around it were an area to which they pay great attention as it helps them assess the company's ability to convert its profits into cash. Our survey of private investors showed that 66% of private investors consider the cash flow statement to be "very important" when making their investment decisions (higher than any other section of the report). In the 2015 QCA/Baker Tilly Small and Mid-Cap Investor Survey conducted by YouGov, one investor commented, "*Over time, pre-tax profits have diverged more and more from cash, which is what matters*".	Cash flow statements are a common area where the FRC finds issues at many quoted companies. Points raised with the smaller quoted companies tend to be straightforward errors or non-compliance. Examples include: • non-cash items, such as conversion of loans to shares, or dividends in specie disclosed as cash movements; and • operating cash flows, for example, recoverable VAT on capital expenditure, settlement of non-hedging derivatives or net cash outflows from contract hire operations misclassified as investing cash flows. Our sample of audit reviews also noted that only a very small number of auditors clearly evidence the work performed to check the accuracy and consistency of the cash flow statements, indicating a lack of focus in this area by auditors.

	What Investors Say	FRC's Findings
Understanding the underlying financial performance of the company	Investors are generally focussed on gaining an understanding of the underlying financial performance of the company in order to make informed investment decisions based on their expectations of a company's ability to sustain or improve its profitability. The income statement provides a good basis for understanding a company's performance but investors raise questions where companies report the following: • References to "exceptional" or "other special" items – whether they are genuinely exceptional or whether they should be included within operating profit; • Adjusted (or non-GAAP) measures – more companies appear to be reporting adjusted profits and other performance measures to exclude "one-off" items which may not fairly reflect a company's performance or its profit trend. Whilst investors find such measures useful there may be a case for greater transparency around how these measures are derived; • Reporting of discontinued operations – whilst investors value the separate reporting of discontinued operations, they may be sceptical as to whether some of the costs should be reported in continuing operations; and • Acquisition accounting – investors report that they have difficulty in understanding the underlying performance of a company that is highly acquisitive, due to the number of items disclosed in the income statement that arise from acquisition reporting and the fair value adjustments to which it gives rise.	Each of the items listed opposite are permitted or required by IFRS but investors are sceptical. Therefore boards should ensure that there is proper explanation of each item to ensure that investors can gain a good understanding of the underlying performance of a company. For example, investors' understanding of a company's performance could be improved by a clear definition of "exceptional" and "one-off" items, consistently applied to debit and credit items and across different reporting periods. The FRC issued a reminder to boards in December 2013 of what they should consider when they present exceptional or similar items and encouraged them to improve their reporting in this area. We encourage smaller quoted companies to take note of this reminder.
Disclosure of accounting judgements and estimates	Investors take particular note of the disclosure of the judgements management has made in its application of significant accounting policies. This facilitates a better appreciation of the range of factors underlying areas of significant judgement and the extent to which management has taken account of them in their financial reporting. Investors prefer to be able to ascertain the impact of management's judgement on the outcomes. Similarly, investors have an interest in understanding the assumptions driving management's estimates and their sensitivity to change.	It is not unusual for the outcome of an FRC query to result in the observation that the judgement or estimate made should be separately reported, and the associated disclosures enhanced.

	What Investors Say	FRC's Findings
	Disclosure of acquisitions is an area of particular focus.	
Accounting policies, in particular revenue recognition and capitalisation policies	Investors pay particular attention to descriptions of significant accounting policies where they may indicate that a company is adopting policies which may be considered to be unusually aggressive or out of line with other similar sized companies in the industry. Such instances are likely to raise concerns among investors. Examples include: • Aggressive revenue recognition policies where similar companies in the same industry do not recognise revenue until later in the sales process; and • Capitalisation of costs where similar companies in the same industry expense such items. The treatment of research and development costs was frequently cited as an example.	Descriptions of accounting policies may often be copied from a financial reporting standard or model set of financial statements with little attention to the company's specific circumstances, sometimes referred to as "boilerplate" disclosure. This is of particular concern in relation to significant policies such as revenue recognition. Companies did not always identify when revenue is recognised across a range of material lines of business where the risks and rewards are transferred at different points. Conversely, we noted that some smaller quoted companies disclosed copious descriptions of forthcoming changes in reporting standards that were not at all significant to their future reporting and which could have been deleted. Our sample of audit reviews showed that, in most cases, there was little evidence of the work performed by the auditors to review and assess the appropriateness of the policies applied by the companies to their financial reporting. Narrative disclosures included in the notes to the annual report attracted little obvious attention.
Provisions – both new provisions and those released during the year	Investors are clearly interested in provisions or contingent liabilities disclosed in their financial statements as this provides an indication of the future restrictions on a company's ability to generate a positive cash flow. Where there are inadequate explanations for such items investors may be wary of investing.	The FRC often finds that companies do not focus on disclosing the reasons for the movements in provisions and we have on occasion asked companies to provide more granular information when the aggregated disclosure leaves the investor unclear as to their nature.

3.3 Improving the quality of reporting

Resource constraints are at the heart of the challenge for smaller quoted companies. Companies that do not believe that investors read annual reports are likely to devote a bare minimum of scarce resources to their production. There are also a number of other contributing factors to poorer quality reporting in this market segment.

Overall, our analysis suggests that there are four areas where sharper focus could help smaller quoted companies improve the quality of their annual report:

- Adequate *time and resources* available to produce good quality annual reports;
- Early engagement on the annual report by *those charged with governance*;
- Deeper understanding of *relevant reporting standards and requirements*; and
- Appropriate rigour by the *auditors* in the review of annual reports.

3.3.1 Time and resources

We found that the most significant challenge facing smaller quoted companies relates to the adequacy of appropriate resource to prepare the annual report, which often results in the their preparation being left until the last minute. This places pressure on both the finance function and auditors to finalise the annual report in a short space of time, which may have an adverse impact on quality.

Generally, the cost of being listed or admitted to AIM (in particular in relation to preparation of IFRS financial statements) is proportionately greater for smaller companies than for their larger counterparts. The size and expertise in the finance function does not necessarily increase post listing or admission to offset the increased requirements. In addition many smaller quoted companies do not have an internal audit function.

The purpose of listing may also have an effect on a company's attitude to reporting; some companies seek admission to the market purely for a one-time capital raising. The shares in such companies can often be held by a small number of individuals or entities and trading is illiquid. Such companies tend to be less interested in ongoing engagement with investors and may approach reporting with a compliance mind-set.

Our survey of finance directors showed that, while these companies use legal and other external advisors, very few seek assistance with the preparation of their financial statements from another firm of accountants.

Smaller quoted companies often face working capital challenges as they seek to grow, which is an example of a barrier to providing more dedicated resource for financial reporting. In addition, we found that they may struggle to build the infrastructure required for management and other reporting at the same pace with which they grow. Thus the systems in place can quickly become inadequate for the size and complexity of the business.

There often appears to be a lack of appreciation of the additional resource required on an ongoing basis after an IPO, raising questions about how adequately prepared such companies are for the continuing obligations of life as a public company and whether they are receiving appropriate advice from their accountants, sponsors and Nominated Advisors ("NOMAD") on their ongoing reporting obligations at the point of listing.

Sponsors are required to provide a number of assurances to the Financial Conduct Authority ("FCA") in relation to whether an issuer has appropriate systems and controls or the impact a transaction may have on an issuer. The FCA is currently working closely with the sponsor community to develop a common understanding of the FCA's expectations of them when performing this work. Over the next year, the FCA expects to hold a series of roundtable discussions, in addition to having regular engagement meetings with individual firms, educational sessions and issuing additional guidance where necessary.

In addition to the issues outlined above, the FRC has frequently drawn minor presentational issues to the attention of the boards of smaller quoted companies which indicated a lack of care in their preparation. Examples include:

- inconsistencies between the narrative reports and the financial statements;
- inconsistencies between the primary financial statements and the relevant notes, even when cross referenced;
- incorrect identification of accounting standards;
- typographical errors; and
- spelling mistakes.

3.3.2 Those charged with governance

Our discussions with stakeholders have highlighted the importance of the tone at the top of the company. Investors place value on board members who have a good track record. Finance directors report that the preparation of the annual reports is made easier and more effective where there is board expertise and engagement in the financial reporting process.

Smaller, growing companies understandably often appoint non-executive directors for commercial reasons rather than their independence or financial reporting expertise. It has been suggested that the management of smaller quoted companies tend not to be subject to the same degree of rigorous challenge by their board on the quality of the annual report as larger companies. 52% of respondents to our survey of finance directors indicated that their audit committee or board provides only limited challenge to the annual report and financial statements.

Our analysis of the governance arrangements at 60 smaller quoted companies, the great majority of whom were AIM companies, found that, overall, 50% of our sample met all three of the key corporate governance indicators (chair/CEO separation; at least two independent non-executive directors plus the chair; and at least two non-executive directors on the audit committee). Of the companies that did not meet with all three indicators, all except one company were AIM companies. Whilst there was a high level of adherence to the key principle of having a separate chair and CEO, 46% of the AIM companies in our sample did not comply with the other two key indicators of the quality of governance as set out in the UK Corporate Governance Code.

A number of companies and auditors we spoke to observed that it may be beneficial to have a Corporate Governance Code for AIM to provide clarity and consistency of expectations for the governance of AIM companies.

Companies quoted on AIM are not required to apply the UK Corporate Governance Code. However, since May 2014, all AIM companies have been required to disclose via their website, details about the corporate governance code they adopt and how they comply with the chosen code or, if no code has been adopted, to state this fact together with a description of the company's corporate governance arrangements. One such code is the Quoted Companies Alliance ("QCA") Corporate Governance Code for Small and Mid-Size Quoted Companies which is specifically tailored for smaller quoted companies including those admitted to AIM. We recommend that all companies have at least one non-executive who has the relevant financial expertise and that the board consider adopting the principles of accountability as set out in Section C of the UK Corporate Governance Code, particularly in respect of the audit committee and auditors.

Those charged with governance have an important role to play in making a proper assessment of the adequacy of a company's financial reporting process. Auditors can contribute to this process by making an early assessment of the competence of the finance function and reporting any weaknesses to the audit committee.

Our reviews of the audits of smaller quoted companies found little evidence that unadjusted disclosure misstatements were reported to boards and audit committees. Improvements in collating and communicating unadjusted disclosure misstatements to boards and audit committees would assist them in discharging their responsibilities for the annual report and financial statements and enhance the engagement of non-executives in the financial reporting process.

A number of auditors felt that the extended auditor's report was fostering more engagement with the board, encouraging them to think carefully about their own risk statements and promoting better alignment between the front and back of the annual report. The new requirements for auditor's reports apply to companies subject to the Corporate Governance Code with effect from 1 October 2012. The auditor is required to report by exception on the "fair, balanced and understandable" statement by the board and the audit committee's report, and to provide greater transparency about the audit[2]. The FRC has published a review of the first year's experience of extended auditor's reports https://www.frc.org.uk/Our-Work/Publications/Audit-and-Assurance-Team/Extended-auditor-s-reports-A-review-of-experience.pdf.

3.3.3 Relevant reporting standards and requirements

Many preparers and investors consider that annual reports have become too long and unnecessarily complex. The objective of IFRS is to provide investors with relevant information. However, the application of the detailed requirements may lead to less relevant information being produced. There can, for example, be a reluctance to remove immaterial disclosures for fear of being questioned by regulators. It also takes significant effort and time to make judgments on materiality and consequently, once a disclosure is included, it is easier to just "leave it in".

Respondents to our survey of finance directors most commonly cited financial instruments, share-based payments and directors' remuneration reporting as the requirements that gave them most difficulty, took up a substantial part of their time and which they did not consider to be particularly relevant or useful. Auditors observed that companies sometimes do not appreciate the complexity of the financial instruments they enter into until they are required to consider their accounting treatment.

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[2] Greater transparency was addressed by requiring auditors to include within their reports:

a) A description of those assessed risks of material misstatement that were identified by the auditor and which had the greatest effect on the overall strategy; the allocation of resources in the audit; and directing the efforts of the engagement team;
b) An explanation of how the auditor applied the concept of materiality; and
c) A summary of the audit scope, including an explanation of how the scope was responsive to the assessed risks of material misstatement described in (a) and the concept of materiality as described in (b).

Those responsible for financial reporting at these companies understandably find it challenging to keep up to date with changes to accounting standards and reporting requirements and often rely on their auditors to provide them with advice. Chartered accountants are required to maintain their level of competence through continuous professional development (CPD). We found some scepticism over the effectiveness of the CPD regime, with one auditor observing:

"It is too easy for accountants to tick off CPD requirements without getting appropriate training and technical updates."

Auditors then face challenges on the extent to which they can advise companies due to restrictions in their ethical standards which are in place to guard against the risk that they could effectively be auditing their own work. The precise boundary is open to interpretation and we have found that many audit firms err on the side of caution for fear of being criticised by the FRC. However, we found only very limited support across all groups of stakeholders for a relaxation of the ethical standards for auditors. Nevertheless, auditors should be able to engage with companies on accounting matters and there was support for more clarification on the boundary.

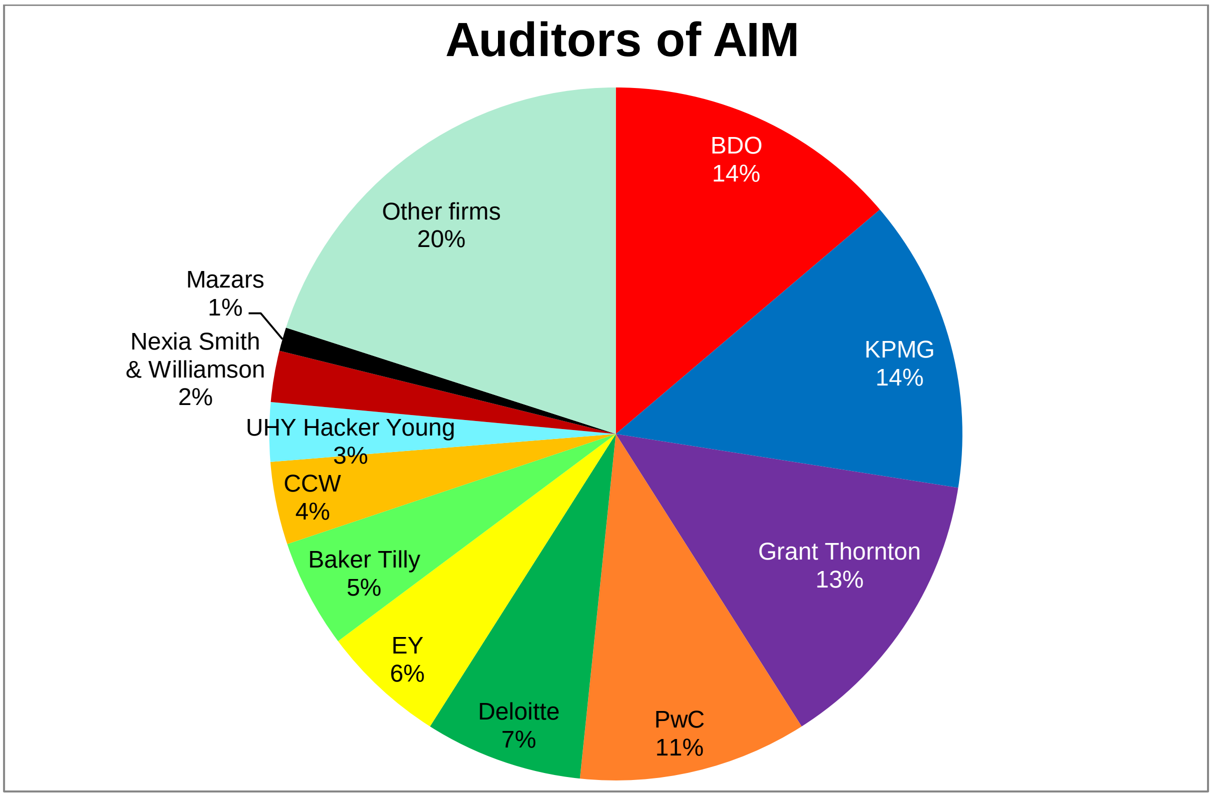
Our stakeholder engagement has sought to identify whether there is any appetite for allowing AIM quoted companies to report under UK GAAP as an alternative to IFRS. The overwhelming response from investors, auditors and preparers was that this would not be a welcome step as it would reduce comparability and could discourage potential investment. Preparers and auditors also commented that IFRS is now familiar. It was accepted that the implementation of IFRS was an appropriate hurdle for companies to achieve when seeking to list / become quoted.

However, the general consensus from all stakeholders we spoke to was that they would welcome reduced disclosure requirements for smaller companies in areas which were not as relevant for their businesses as long as the underlying accounting framework was consistent. Stakeholders also considered that the introduction of FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*, which is largely based on IFRS should help the transition to IFRS on listing.

AIM quoted companies have a six month reporting deadline compared to the shorter, four month deadline for companies with a full listing. During our discussions with stakeholders it was pointed out that the extended reporting period for AIM encourages last-minute preparation and can discourage investment in those companies that make full use of the six months. Similarly, a long gap between issue of preliminary announcements and the issue of audited full financial statements is a concern for investors because it could suggest there is a problem with the financial statements.

3.3.4 The role of the auditors

Auditors clearly have an important role to play in raising the overall quality of smaller quoted company reporting. As the graph below demonstrates, there are a large number of audit firms with AIM-listed clients. 88 firms audit the 1,088 companies listed on AIM as at the end of February 2015.



Our audit quality reviews[3] in the last five years have shown that, amongst listed companies, those outside the FTSE 350 continue to account for the largest number of audits assessed as requiring significant improvement (18 in total). This represents 16% of smaller listed audits inspected in this period. By contrast only 7% of all FTSE 350 audits inspected were assessed as requiring significant improvements. This correlates with concerns from our review of the annual reports of companies that the quality of financial reporting by some smaller quoted companies is lower.

Whilst we found that audit firms generally had appropriate policies and procedures in place to ensure that financial statements were appropriately reviewed before publication, a lack of rigour by some audit teams in following these policies and procedures, often when there is significant time pressure, was a contributing factor in lower quality reporting. In conducting our reviews we noted there were a number of annual reports where the auditors had failed to identify basic reporting errors. Audit firms inform us that this may, in part, be due to the lateness of receiving draft annual reports to review. In our reviews we noted that the dates of the audit reviews were indeed generally very close to the completion deadline. While time pressure and late drafts are a challenge, the quality of the audit should not be allowed to

3 Audit Quality Inspections Annual Report 2014–15.

suffer and auditors should consider deferring their opinion if they have insufficient time to conduct the audit to an appropriate standard.

The audit process involves a number of quality control processes by the audit team, including the partner, manager, engagement quality control reviewer and the technical reviewer. As there are a number of individuals involved, responsibilities may become blurred and errors or misstatements may not be identified or corrected.

We identified that many smaller audit firms do not require technical reviews to be carried out by specialist staff and do not always require partners to be IFRS accredited.

We concluded that tightening audit practice and procedure in a number of areas would increase the effectiveness of the audits. Areas for improvement include:

- clearly defining responsibilities;
- increased and more rigorous use of technical review;
- more rigorous training and experience thresholds for audit engagement partners undertaking quoted company audits;
- improvements in procedures around the collation and reporting of unadjusted audit misstatements;
- improved procedures at the final completion stages of the financial statements;
- greater focus on cash flow statements;
- more focus on evaluating the competence of management to produce high quality annual reports and financial statements at an early stage of the audit;
- a focus on the adequacy of the audit procedures performed over financial statement disclosures and the impact on quality; and
- improved communication with audit committees of unadjusted disclosure misstatements and management's technical competence to produce good quality financial statements.

4 How could the FRC help?

The FRC has identified a number of ways to assist smaller quoted companies to improve the quality of their financial reporting.

Communications with investors

There is a perception gap between smaller quoted companies and investors in respect of the value of the annual report. The FRC believes that smaller quoted companies will have more success at engaging investors if they view the annual report as an opportunity to communicate with investors and focus on investor priorities.

The FRC believes it has a role to play in the process of narrowing the perception gap and as such proposes to:

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

- **look for opportunities to facilitate greater dialogue between smaller quoted companies and investors, for example through roundtables and similar initiatives;**

- **create more pressure on investors and rating agencies to provide feedback to companies on their annual report; and**

- **encourage more participation by smaller listed and AIM 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 that better meets the needs of both, and explore additional methods of sharing with small companies the innovative suggestions developed in the Lab and tested with investors, so they can be put into practice.**

Resourcing

The FRC recognises that these companies have resource constraints and that it can support them by providing relevant guidance and training resource.

To assist companies to make maximum use of their resources the FRC will:

- **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 CPD requirements;**

- **discuss with the accountancy and audit Professional Bodies whether the CPD regime could do more to support finance staff in keeping up to date with reporting requirements; and**

- **against the backdrop of the implementation of the EU Audit Regulation and Directive, review whether the process of granting Responsible Individual status could be improved to ensure that audit partners are suitably qualified and experienced to carry out audits of listed or AIM quoted companies.**

AIM Companies

AIM quoted companies are not required to apply the UK Corporate Governance code and this may result in less governance over the reporting process and less focus from non-executives on the quality of corporate reporting. NOMADs do not have specific responsibility to review or approve the annual report. The quality of reporting therefore depends on the degree of importance attached to it by the finance function and the board. Shareholders can, of course, effect change and hold companies to account if they have governance concerns. Nevertheless, some stakeholders reported they would prefer AIM companies to have a Corporate Governance Code that they are required to follow.

It was also suggested that:

- the extended reporting period for AIM companies encourages delayed reporting which can have an adverse impact on quality and investor confidence; and

- adopting the extended auditor report for AIM companies could have a positive impact on the quality of engagement and reporting.

We have discussed these findings with the London Stock Exchange and will work together to find ways to ensure that companies understand the importance of, and have appropriate financial reporting resources to meet, their ongoing reporting obligations on admission to AIM.

Corporate Governance

The FRC agrees that boards and audit committees play an essential role in the preparation of annual reports and financial statements that comply with the applicable reporting framework and which are clear and concise.

The FRC recently published a practice aid for audit committees to evaluate the effectiveness of their auditors https://frc.org.uk/Our-Work/Publications/Audit-and-Assurance-Team/Audit-Quality-Practice-Aid-for-Audit-Committee-(1).pdf .

The FRC will supplement this with practical guidance for audit committees and boards of smaller quoted companies on evaluating the adequacy of a company's financial reporting function and process.

The FRC will consider whether it could assist by providing boards and audit committees with other focussed guidance, e.g. on changes to standards and other requirements.

The resourcing pressures smaller quoted companies are under suggest that for these companies in particular, a non-executive with recent and relevant financial expertise could add significant value to the reporting process. The FCA's Disclosure and Transparency Rules ("DTR") require that at least one member of the audit committee has competence in accounting and/or auditing for listed companies. The FRC would encourage AIM companies, who are not required to apply the DTR or UK Corporate Governance Code, to consider carefully the principles of accountability as set out in Section C of the Code.

Consistent Financial Reporting Framework

There is a strong consensus that IFRS should remain the reporting framework for all listed companies, including AIM; market participants value consistency and accept that IFRS is the right approach. However, there is a desire for increased stability in IFRS, meaning less frequent changes to the standards, and for reduced disclosure for smaller quoted companies.

The FRC will continue to influence the IASB and other standard-setters to ensure that the frequency of changes to standards is proportionate and considers their relevance to all companies, including smaller quoted companies.

Consistency and comparability of the annual report

We will also seek to address investors' perception that there is a lack of comparability between similar companies in areas such as capitalisation of assets and revenue recognition or where companies report alternative performance measures and/or include one-off or "exceptional items" in their annual report.

To address these concerns, the FRC will:

- **highlight the Financial Reporting Lab's Accounting Policy report (https://www.frc.org.uk/Our-Work/Publications/Financial-Reporting-Lab/Accounting-policies-and-integration-of-related-fin.aspx) to smaller quoted companies emphasising the need for companies to clearly identify and explain their significant accounting policies to investors;**

- **highlight our press notice on alternative performance measures to ensure that any such measures are clearly explained with a proper reconciliation to statutory profit; and**

- **seek to influence European and international developments relating to alternative performance measures such as ESMA's Guidelines to ensure that it addresses investors' concerns in this area.**

Application of materiality and disclosures

Preparers consistently cite financial instruments disclosures, share-based payments, and pension disclosures where the size of the defined benefit pension scheme is very small, as the areas where the length of disclosure may not appear relevant to smaller quoted companies or add little value for the amount of effort that goes into preparing them. While these aspects may not be core to the business of smaller quoted companies, they are nevertheless relevant where companies have complex or significant transactions or arrangements.

Where the value of these transactions is very small in the context of the overall business, smaller quoted companies and their auditors can apply the materiality test and if appropriate exclude them from the disclosures in the financial statements. Whilst the application of materiality to disclosures is more difficult than for measures in the income statement for example, we would encourage smaller quoted companies and their auditors to take a robust approach to materiality and to use their judgment in order to keep annual reports clear and concise. This should reduce the burden on the finance function. Many larger companies have taken steps to reduce the level of disclosure where the information is not material to the financial statements which have made the annual report clearer and more concise for investors.

A number of recent initiatives by the FRC and other bodies such as ESMA and the IASB have considered the application of materiality in financial statements. We will continue to seek ways of providing further clarity on materiality and in particular, how the materiality framework may be applied to disclosures.

The FRC's initiative on Clear & Concise Reporting encourages companies to provide only relevant information in an easily accessible format. Smaller quoted companies may find the outputs of the Clear & Concise initiative a relevant point of reference https://frc.org.uk/Our-Work/Headline-projects/Clear-Concise.aspx.

The FRC will:

- **consider whether Capital Markets Union provides an opportunity to develop a differentiated disclosure framework for smaller quoted companies, building on the IFRS-based approach adopted in UK GAAP; and**

- **include specific consideration of smaller quoted companies in its Clear & Concise reporting initiative and encourage participation by smaller quoted companies in its series of Clear & Concise case studies.**

Role of the Auditor

There was broad consensus among stakeholders that objectivity and independence requirements in the ethical standards for auditors that prevent them from becoming involved in accounts preparation, are appropriate and set at broadly the right level in allowing auditors to provide management with accounting advice on matters that have come to their attention during the audit without directly providing accounting services. Whilst there may be some need for clarification, there was only limited support for any change in the standards.

The FRC is undertaking a review of its ethical standards for auditors in 2015 and, as part of that review, will consider whether greater clarity is needed for auditors on the extent to which it is appropriate for them to advise on reporting matters.

The FRC believes that more rigour in the audit process would have a positive effect on the quality of reporting. Auditors play a crucial role in the reporting process and therefore have scope to significantly influence the quality of their clients' reporting. After reporting the FRC's detailed findings to the audit firms, these firms have identified a number of ways to improve their processes and procedures and raise awareness of the issues that the FRC identified from its reviews of annual reports. These include:

- Early communication of any concerns that the audit team have over the quality of the finance function which will help the company to address these issues before the report is due to be prepared.

- Increased involvement at an earlier stage of the audit by partners and staff who carry out the technical review of the financial statements so that reporting issues can be addressed in a timely manner.

- Improvements in the support provided to audit teams to ensure that common issues identified by the FRC are addressed.

- Training and guidance to audit partners and staff who are involved the audits of smaller quoted companies.

- The creation of working groups to specifically address the challenges faced by these companies.

It would also seem logical that the use of model financial statements plays a role in the quality of the financial statements, but whether it is the model financial statements themselves or simply inappropriate use thereof that contributes to poorer quality reporting is unclear. The FRC would therefore encourage auditors and preparers to assess, during the early stages of the preparation of the financial statements, whether the use of model financial statements is appropriate and the extent to which they need to be tailored to the company's circumstances.

The FRC will monitor the changes that audit firms are making to their processes and procedures in response to the FRC's findings. We will also encourage the Quality Assurance Department ("QAD") of the ICAEW to monitor whether improvements are made at smaller audit firms.

The FRC (and auditing standards) also consider that the Engagement Quality Control Review ("EQCR") process has an important role to play in ensuring that the audit team complete their procedures over the finalisation of the financial statements. The FRC intends to carry out a thematic study on the EQCR role during 2015. A further thematic study will be carried out on audit firms' internal quality control procedures. Both of these studies may identify further areas of improvement in the auditors' consideration of reporting matters.

5 Conclusion and Next Steps

This project has 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 support this objective the FRC has set out above a number of proposals to facilitate improvements in the quality of reporting.

We look forward to receiving comments on this report from investors, companies, auditors, advisors and other interested parties as we seek to implement the proposed actions. We welcome any comments on the report but we would be particularly interested in responses to the following questions by 31 July 2015:

- **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?**

Our next steps will be to:

- Hold an open meeting, on 9 July 2015, to discuss the findings in this report and encourage participation in finding solutions to the issues identified.

- Consider the feedback received on this discussion paper in conjunction with the comments received at the open meeting.

Subject to assessing the feedback we receive, we will take steps to implement the proposals in this report, working with others, such as the QCA and the Professional Bodies, as appropriate. We will also contact specific groups of stakeholders to seek their support in addressing some of the issues identified.

Appendices

Principal findings of the Five Evidence Strands

1 Corporate Reporting Review – Common Themes

1.1 Objectives and scope

CRR annually review some 250 annual reports and raise questions of boards where there is, or may be, a question of non-compliance with relevant reporting requirements. CRR resource is directed towards companies of greatest economic significance where a material error could have implications, not just for the individual company but for the market as a whole. The selection of annual reports for review, however, is drawn from across CRR's full remit which includes listed, UK AIM quoted and large private companies. The sample is spread to ensure reasonable coverage of the relevant markets and enabling broad qualitative comparisons to be made.

Most CRR cases close with the company volunteering corrective or improving actions in its future financial reports. Where clear undertakings are sought, CRR check that the company follows through on their commitments. Where they are not given as expected CRR follow up with the company.

Where smaller quoted company reports have been reviewed twice or more over the past ten years it is encouraging that, once undertakings have been given, the companies generally maintain their enhanced disclosures. The second and subsequent review, absent a change in the reporting requirement or in the company's business model or activity, does not usually generate further significant queries.

Annual activity reports published by CRR and its predecessor body have, in successive years, referred to the poorer quality of reporting which it notes more often in the annual reports of the smaller quoted companies (defined by CRR as all below the FTSE 350) – and UK AIM quoted companies. In contrast to the other work strands included in this report, CRR's contribution to the smaller quoted company project is the findings of its routine monitoring work rather than a discrete thematic review conducted specifically for the purpose of the study.

1.2 Approach / methodology

Following publication of CRR's 2013 annual report, the issues and outcomes of CRR's enquiries of smaller quoted boards for evidence of common themes were analysed. The analysis was subsequently extended to include the findings of the sixty-five such cases which were closed in the two years to 31 March 2015 following exchanges of correspondence. The length of time taken to conduct a case ranges considerably and the reports include those for accounting periods ending between December 2012 and June 2014.

Of the 65 companies, 35 were fully listed on the UK market and the balance were AIM quoted. All but eight companies were audited by the nine audit firms currently within the scope of AQR inspection[4].

[4] See Appendix 2 for a list of these firms.

An analysis was carried out of the issues raised by relevant reporting standard or other legal requirement to determine whether there were any areas of apparent and particular difficulty for smaller quoted companies. CRR also considered the nature and qualitative aspects of the questions put to such companies compared with those commonly put to larger companies.

1.3 Findings

This analysis did not identify any specific area of financial reporting that was raised exclusively in respect of smaller quoted companies. Requests for further information and explanations to help understand a company's reporting covered the full range of IFRS and Companies Act disclosures.

As with the larger companies, some standards generated more questions of management than others. Some technical reporting points were, however, rather more prevalent in the reports of the smaller quoted companies than their larger peers although not exclusively. The specific points were usually of a more straightforward nature although some smaller quoted companies were faced with the challenge of applying IFRS to a complicated set of circumstances or fact pattern.

The CRR activity reports covering the two year period under review highlighted CRR's common areas of questioning which remained reasonably constant across the period. The analysis identified the following key areas where there were proportionately more questions included in the approaches to the smaller quoted companies:

Business review and strategic reports

More requests for clarification were put in respect of business reviews and strategic reports than any other area of corporate reporting. The review provides management with the opportunity to provide shareholders with broader context and analysis from which to better understand the reported results. Queries were raised where the review did not appear to be balanced or comprehensive, as required, or where it appeared inconsistent with other information in the annual reports, including:

- Failure to identify their principal risks and uncertainties and action taken to mitigate their effects;

- Poor or limited explanation of performance or failure to identify components of growth or profit – for example:

  - that growth was due to acquisitions rather than organic expansion; or
  - that the reported profit was wholly due to changes in amortisation rates; and

- Limited reference or inadequate analysis of material or exceptional items.

Accounting policies

CRR write to boards for additional information when it is not clear from the disclosures in the financial statements whether or not there is potential non-compliance. Poor descriptions of material accounting policies were a source of a number of queries.

There was a greater tendency for the financial statements of smaller quoted companies to include descriptions that had been copied out from the financial reporting standard or model set of financial statements with little attention to the company's specific circumstances. On occasion, this extended to disclosing options permitted by the standard but without identifying which had been applied. Conversely, policies were included which were clearly not relevant to the company's business and performance and are therefore unnecessary. CRR pay particular attention to the sufficiency of revenue recognition disclosures where a number of smaller quoted companies did not identify the points at which revenue is recognised across varied lines of business – for example, a software company not distinguishing its revenue recognition policy for licenses from its policy for subscriptions.

Conversely, CRR noted on occasion that some companies disclosed copious descriptions of forthcoming changes in reporting standards that were not significant to their future reporting and are therefore unnecessary.

Complex or unusual transactions

Smaller quoted companies face the same technically demanding challenges as their larger counterparts when they enter into more complex or unusual transactions or develop complex arrangements, for example certain types of share-based payment arrangements. CRR questioned a number of boards where their reports were not clear as to how they had accounted for such items which were often transactions of which they had no previous experience; for example, share consolidations and how they impact EPS calculations, forward contracts for foreign currency or how to reflect a vendor's continuing employment following a business combination. Subsequent exchanges with boards sometimes indicated a lack of familiarity with the underlying requirements as these transactions or arrangements usually occur infrequently. Occasionally, questions were raised for simpler items, for example the reporting consequences of reclassifying intangible assets as goodwill.

Cash flow statements

Cash flow statements have remained a common area of queries for smaller quoted companies; the issues have tended to be straightforward errors or non-compliance; for example, non-cash items, such as conversion of loans to shares, or dividends in specie disclosed as cash movements. Operating cash flows, for example, recoverable VAT on capital expenditure, settlement of non-hedging derivatives or net cash outflows from contract hire operations have been misclassified as investing activities. CRR pay particular attention where the apparent errors materially impact operating cash flows.

Presentational issues

Looking beyond compliance with financial reporting standards, cases opened in respect of the smaller quoted company annual reports often raised points of presentation which indicated a certain lack of care in their preparation. For example, apparent inconsistencies in the notes or with the primary statements even when cross referenced, incorrect identification of relevant standards; typographical errors and spelling mistakes – indicative, perhaps, of a lack of care or adequate resource.

2 Audit Quality Thematic Review – AQR and QAD Findings

2.1 Objectives and scope

The Audit Quality Review ("AQR") team carried out a review of the procedures performed by auditors in the audit of the presentation of, and the disclosures in, the annual report of smaller quoted companies. The Quality Assurance Department ("QAD") of the ICAEW conducted a similar review for the same purpose.

2.2 Approach / methodology

AQR visited the nine audit firms currently within the scope of AQR inspection (Baker Tilly, BDO, Crowe Clark Whitehill, Deloitte, EY, Grant Thornton UK, KPMG, Mazars and PricewaterhouseCoopers) to review their audit methodology and guidance and training provided to staff in respect of the quality of financial reporting and, specifically, in relation to smaller quoted companies.

AQR reviewed relevant aspects of the audit procedures performed for 27 smaller quoted companies. These related to audits of financial statements for year ends between December 2012 and December 2013. The reviews focused on the audit procedures performed by audit teams to review the accuracy, completeness and adequacy of the presentation of, and disclosures in, the financial statements.

As a significant minority of smaller quoted companies are audited by firms other than the nine firms under the scope of regulation of the FRC's AQR team, the QAD of the ICAEW conducted a similar review at 22 other firms both through visits to eight firms and through questionnaires completed by 14 firms.

2.3 Findings

The reviews identified a number of different practices by audit firms and AQR have made recommendations to the audit firms where there are good practices that could be more widely applied and where other improvements should be made. The observations are based on the reviews carried out and each has been discussed with the audit firms concerned. The findings of QAD's thematic review are generally consistent with AQR's findings but where QAD's findings are specific to the other firms these have been highlighted. The key messages are therefore applicable to all firms that audit smaller quoted companies.

The sections below provide an overview of areas of good practice observed and principal findings and key messages for audit firms.

Good practice observed

During the course of the review there were some areas of good practice which led to an improvement in the quality of the presentation of, and the disclosures in, the annual report and financial statements in the audits reviewed:

- Audit teams gave some good explanations as to why they had answered disclosure checklist questions in a certain way. In particular, they explained that disclosures had not been included on the basis of materiality, indicating that audit teams may be having regard to initiatives such as the FRC's Clear and Concise project.
- Performance of a technical review of the financial statements by the firm's central technical accounting team.

- Procedures requiring audit teams to include disclosure misstatements separately on the summary of unadjusted audit misstatements and report them to the board or audit committee.
- Procedures requiring audit teams to complete audit work papers for each primary statement and supporting note to the financial statements to agree them through to underlying audit procedures to evaluate the adequacy of any related disclosures and to perform additional audit procedures if necessary.
- In a minority of cases, providing feedback to the board or audit committee on the strengths or weaknesses in the company's finance function.
- Allowing only individuals designated or accredited by the firm for listed company audit work to act as Responsible Individuals on these audits.

All firms are recommended to consider these good practice observations and implement such procedures, where appropriate.

Key messages for audit firms

All firms have established quality control procedures for the audit of the presentation of, and the disclosures in, the annual report and financial statements of smaller quoted companies. Some matters require firms to consider improvements to their procedures and some require improvement in the audit teams' application of these procedures in practice.

It is often the case, when there is significant time pressure to complete the audit of the financial statements, that the quality of the audit procedures performed may fall below the level expected. The process to audit the annual report and financial statements involves a number of quality control processes by the audit team, the partner, manager, EQCR and the technical reviewer. All of these individuals should remain focused on their contribution to the quality control process, ensuring that all audit team members apply the audit procedures at the required level of quality, particularly as the completion deadline approaches.

Neither AQR nor QAD identified any material deficiencies which would indicate that an inappropriate audit opinion may have been issued. However, AQR and QAD identified a number of immaterial errors, omissions and inconsistencies in the annual reports and financial statements reviewed and therefore there are areas where auditors should improve the quality and effectiveness of the audit procedures performed and reduce the risk of such deficiencies arising in the future.

Overview of findings

The principal findings arising from the review are set out below:

- All firms reviewed by AQR have a number of quality control procedures over the annual report and financial statements, including completion of disclosure checklists, reviews by members of the engagement team, including the EQCR, and a technical review by an accounting specialist. The responsibilities of the individuals involved in these procedures varied between firms and in some cases it was not clear whether these responsibilities were clearly defined or, in some cases, whether they were appropriate. As a large number of individuals are involved in the operation of these quality control procedures the lines of responsibilities may get confused and errors in the annual report and financial statements may not be identified and corrected.

- There are several differences in the structure of audit firms' technical review functions, the level of information received by the technical reviewer, the responsibilities for dealing with the points raised by the reviewer and whether smaller quoted companies require technical review. This may affect the quality and effectiveness of these reviews.

- Only a minority of firms reviewed by QAD had a separate technical review function with some firms incorporating this in the EQCR process and only half required audit engagement partners to meet training and experience requirements for listed company audits. There was little standardisation in the documentation of technical reviews, including who was responsible for the clearance of points raised and how this was evidenced. QAD's reviews indicated that these procedures did not appear to be fully effective in a number of cases.

- At most firms the templates for the summary of unadjusted audit misstatements are not designed to collate misstatements relating to disclosures. Significant judgment is involved in assessing materiality for unadjusted disclosure misstatements and further guidance and training provided by firms in this area will assist audit teams to determine whether these should be adjusted or included on the summary as unadjusted.

- There was little evidence that unadjusted disclosure misstatements were reported to boards and audit committees even though this is required by Auditing Standards. Improvements in collating and communicating unadjusted disclosure misstatements to boards and audit committees would assist them in discharging their responsibilities for the annual report and financial statements. This should include suggesting the removal of immaterial disclosures.

- There tends to be a lack of attention at the final completion stages of the financial statements resulting in basic errors not being identified on some of the audits reviewed, similar to those identified by CRR. Improving the procedures to agree the financial statements to the audit work performed, to perform additional audit procedures where necessary and to process late adjustments, would better position auditors to identify, record and correct errors prior to the finalisation of the annual report and financial statements.

- At an early stage of the audit, there is a lack of focus at all firms on evaluating the competence of company's management to produce annual reports and financial statements compliant with the applicable reporting framework and other regulatory requirements. Identification of these matters would help audit teams plan appropriate audit procedures at an earlier stage of the audit.

- There were a number of inconsistencies between the cash flow statements and the other primary financial statements which had not been identified by the auditors. Only a very small number of the audits reviewed clearly evidenced the work performed to check the accuracy and consistency of the cash flow statements, indicating a lack of focus in this area by auditors.

3 Stakeholder engagement

3.1 Objectives and scope

The FRC undertook a programme of engagement with stakeholders designed to:

- identify their key concerns relating to the quality of smaller quoted company reporting;
- build a fuller picture of the challenges faced by smaller quoted companies;
- gain a greater understanding of the expectations of stakeholders in relation to the financial reporting of these companies; and
- assess the impact of poor quality financial reporting.

3.2 Approach / methodology

The FRC met with stakeholders from the following groups:

- Investment fund managers who focus on small companies, investor groups and with the UK Shareholders Association.
- Other users – credit rating agencies and banks.
- Smaller quoted company finance directors.
- Audit committee chairs, non-executive directors, board and NED advisors.
- Professional and representative bodies – CIMA, ICAEW and the Quoted Companies Alliance (QCA), which is the independent membership organisation that represents the interests of small to mid-size publicly traded companies.
- Professional advisors, including representatives from each of the nine largest audit firms and NOMADs for AIM quoted companies.
- The UK Listing Authority and London Stock Exchange.

In total around 50 interviews took place supplemented by two surveys (one of finance directors and another of private investors) and we attended several roundtable discussions with smaller quoted company audit chairs and directors.

Stakeholders had an opportunity to raise issues of concern but the discussion focussed on a number of key areas that we wanted to explore. This included testing a number of propositions around possible contributors to poorer quality reporting in order to gauge the degree to which stakeholders support change in those areas, specifically:

(i) the requirement for AIM quoted companies to report under IFRS (for group financial statements);
(ii) the extent to which the complexities of financial reporting standards present difficulties for companies;
(iii) whether independence requirements in the ethical standards for auditors (or perceptions of the constraints imposed on auditors by the ethical standards) prevent companies from obtaining advice from auditors on disclosures;
(iv) whether smaller quoted companies have the right resources to produce good quality financial statements; and
(v) the extent to which weak governance is a factor in poorer quality reporting.

3.3 Findings

Investors

The quality of reporting by smaller quoted companies is generally regarded by investors as being of a good standard, although some investors commented that balance sheets in this sector could be more robust, particularly amongst AIM companies. A lack of trading history and transparency presents additional challenges for investors. A number of investors also pointed out that it is difficult to analyse the annual reports where a company is highly acquisitive.

A clear narrative in the front end of the annual report is highly valued and is particularly important for new investments as it helps investors to understand the business model, to work out what companies do, how they generate cash and to analyse the company's use of capital. At the same time, there is support for de-cluttering the annual report where this does not affect overall quality and transparency, for example the inclusion of fewer but more specific key risks is more useful than a long list of general risks.

Other elements of the annual report which investors pay attention to include audit committee and auditor reporting, as well as management incentives and remuneration disclosures. They generally welcome the new audit committee and auditor reporting requirements for those companies who adopt the UK Corporate Governance Code.

Aside from the primary statements, areas of the financial statements to which investors pay particular attention include:

- Cash flows – in particular to gain an understanding of the extent to which the profit of a business translates to cash generation and the extent to which working capital requirements impact on cash flow.
- Certain accounting policies, in particular to understand how aggressively a company recognises revenue and/or capitalises costs (eg. Research and Development costs).
- Exceptional items, discontinued operations and adjusted measures – the extent to which these items are genuinely exceptional/one-off or part of a discontinued business and therefore appropriate to exclude in underlying performance.
- Disclosure of significant accounting judgements and estimates.
- Provisions – both new provisions and those released during the year.
- Acquisitions– the extent to which the underlying performance of a company is not clear due to adjustments made as a result of the recognition, amortisation or impairment of intangible assets (including goodwill) or fair value adjustments made on an acquisition.

Investors reported being satisfied on the whole with the timeliness of publication of annual reports in the UK, although a long gap between announcements and the annual report being issued can be a concern.

Investors are well aware that some smaller quoted companies can find reporting a challenge. They cited fewer internal resources for reporting, limited knowledge of relevant financial reporting standards and requirements, difficulties keeping up with the requirements and building the necessary infrastructure and management information systems, particularly where a company is growing rapidly, as contributing factors.

Investors expressed no major concerns about the complexity of the reporting requirements overall, which are generally regarded as an acceptable hurdle for becoming listed.

There was a general consensus that all quoted companies, regardless of size, should report under the same regime, namely IFRS. Whilst reporting under IFRS is a legal requirement for companies listed on the main exchange, for AIM companies the London Stock Exchange could choose to permit the use of an alternative reporting framework, such as UK GAAP. However, investors had little appetite for this because it would impact on comparability, add complexity to investment decisions and may inadvertently reduce access to capital for AIM companies if investors avoided companies not using IFRS.

Governance and audit

Former owners/founders who retain significant shareholdings and/or majority control are common in smaller quoted companies. In these circumstances, robust board composition and a healthy relationship with management are vital. Non-executive directors are considered to make a difference and investors pay close attention to the quality of non-executives. Investors report being sceptical where individuals who have lost money for investors in the past are involved and would welcome fuller disclosure of the backgrounds of individual board members in the annual report.

The composition of the audit committee also makes a difference and a weak chair can lead to inadequate focus on financial reporting. Investors pay close attention to whether or not there are any (former) auditors or finance directors on the audit committee. Professional expertise is considered to be important particularly given the complexity of the accounting standards and the reporting requirements. For companies that do not have an audit committee, there was a concern from some investors that the company's NOMAD does not (nor is it part of a NOMADs role to) provide the equivalent oversight of the financial reporting process.

When it comes to audit, investors reported that they have greater confidence in the company's financial statements when a larger, well-known audit firm is used. Frequent changes to the auditors are suggestive of potential problems and might raise a "red flag".

Investors considered the independence requirements for auditors appropriate and did not support a relaxation of the rules. Auditor independence is all the more important for smaller quoted companies because there are fewer reporting obligations than for larger quoted companies. Investors agreed, however, that additional clarity about the level of assistance auditors can provide, for example guidance on implementing new accounting standards or specific accounting treatments, might be useful.

Other Users (Credit Rating Agencies, Banks)

Those making or influencing lending decisions pay particular attention to the detail in an annual report. In general, they consider the quality of reporting in smaller quoted companies in the UK is at a good standard. Good quality reporting enables credit rating agencies to apply their rating methodologies without the need to contact the companies for clarifications or explanations. It may not be possible to provide a rating if the quality of reporting is lacking.

Ratings are clearly influenced by the liquidity and credit quality of a company but may also be affected by the quality of the company's control environment and corporate governance arrangements.

Lenders report that they have a particular focus on the following areas of the financial statements:

- cash flows and the quality of the balance sheet – in particular the cash available to service debt;
- information on working capital and movements in working capital during the year;
- the breakdown of assets between tangible and intangibles; and
- funding arrangements and any restrictions on the availability of funds.

Lenders also reported that the choice of auditor, the quality of non-executives and the corporate governance arrangements of smaller quoted companies is important for lending decisions.

In common with the views of investors, lenders and credit rating agencies were not supportive of allowing smaller quoted companies to adopt UK GAAP. They also felt that any relaxation of audit independence rules would be a backwards step.

Preparers and their auditors/advisors

Those responsible for preparing the annual report and their auditors cited constraints on the resources available to prepare the annual report as the most significant challenge. The finance function tends to have numerous other responsibilities and the preparation of the annual report often only becomes a priority when the deadline for reporting approaches. This places pressure on both the finance function and auditors to finalise the annual reports in a short space of time, which can lead to lower quality financial statements.

Those responsible for financial reporting at smaller quoted companies find it challenging to keep up to date with changes to reporting requirements and often rely on their auditors to provide them with advice. Auditors then face challenges on the extent to which they can advise companies due to ethical considerations arising from the risk that they may effectively be auditing their own work. Smaller quoted companies often face working capital challenges as they seek to grow, which creates a barrier to providing more dedicated resource for financial reporting. There is also often a lack of appreciation of the additional resource required on an ongoing basis after an IPO.

Several companies and auditors have reported that the quality of reporting increases where the finance director is supported by a good quality financial controller who will have more familiarity with the requirements of IFRS and is more likely to have been trained in IFRS.

Auditors report that there is a difference in quality where a company, often with a majority owner, raises money on the equity markets as a one-off fund raising exercise, with little interest in engaging with minority shareholders thereafter. In such circumstances there is little incentive to produce good quality reporting for its shareholders or other potential investors.

The shares of many smaller quoted companies are not widely held and trading is illiquid. Companies report that they engage regularly with significant investors, who are typically interested in cash flow, the dynamics of the business and the market in which the company is operating, whether the company is growing quickly, and future investment and use of capital.

A significant barrier to higher quality reporting is a perception amongst companies that investors do not read the annual report, focusing instead on announcements and analyst presentations, and that much of the information is not relevant for investors of smaller quoted companies, which leads to adjusted measures being reported to the market. Of 64 preparers who responded to the relevant question in our survey, 36% said they had received no investor feedback on their annual report and financial statements and a further 30% said their investors told them they had low or no interest. Two-thirds of respondents reported a medium/high level of investor interest in the front end of the report and a low/no level of investor interest in the financial statements.

One preparer commented: *"There is always value in going through the thought process required to prepare the report and accounts properly. However, it seems like disproportionate effort relative to a) our size of business, b) the size of finance team we have, and c) the almost complete lack of feedback we get from any investors on the finished product."*

Another commented: *"Investors rely on the prelim announcement – the Annual Report has become a huge low value added burden."*

Common examples of areas of the financial statements that are perceived to include information that is not relevant to investors were as follows:

- Detailed narrative disclosure requirements for financial instruments, where listed companies may only have a small number of instruments.
- Accounting for share-based payments, where these are often insignificant.
- The requirement to recognise and measure the value of intangible assets on acquisition.
- Pension accounting where the value of the pension scheme is insignificant.
- Remuneration reporting requirements.

However, there is a reluctance to exclude disclosures from the annual report where they may not be material. The reasons reported include:

- The advice received from auditors and legal advisors is that it is better to disclose to avoid any potential regulatory issues (including queries from FRC).
- Excluding disclosures requires thought and judgment and smaller quoted companies do not have the resource to dedicate to this. There is a perception that it would not add any value so it is considered to be a poor use of resources.
- It is safer to leave non-material disclosures in as they may become material in the future.

Some companies and their auditors reported that there can be a reluctance to provide too much information as it may affect the company's competitiveness or share price. Segmental reporting requirements in particular can lead to companies having to publish data that assists their competitors.

However, there was no strong support from either companies or their auditors and advisors for allowing AIM quoted companies to report under UK GAAP, which would send the wrong signal to the market and reduce comparability between companies. IFRS has become the more familiar reporting standard, and in any case UK GAAP is now more closely aligned with the requirements of IFRS. At the same time companies report they would like more stability in IFRS, that is to say less frequent changes to the standards.

There is general frustration at the ever increasing length (and expense) of annual reports and support for simplifying requirements and allowing smaller quoted companies to experiment, for example by moving non-core items out of the annual report and incorporating them by reference. Companies were positive about the Strategic Report, but there is frustration at the increasing complexity of the requirements in the front half of the annual report, and multiple sources for those requirements. Companies would welcome consolidated guidance on what it should contain, who regulates what and what constitutes best practice and good quality.

A further challenge cited by many is falling levels of analyst coverage of smaller quoted companies, which has become increasingly difficult to attract. Some companies believe this has had an impact on their access to investors/equity capital.

Governance and audit

Companies reported that good governance arrangements lend more discipline to the reporting process and that the extent to which the board and/or the audit committee consider good quality reporting to be important and are engaged in the preparation and review of the annual report has a significant impact on quality.

Often, however, non-executive directors of smaller quoted companies are selected for commercial reasons rather than their financial reporting expertise and therefore are more focussed on the growth of the company than the quality of its reporting. Where a company is AIM quoted and not applying the UK Corporate Governance code, this can result in a lack of oversight and accountability for the annual report. Whilst NOMADs provide assurance over compliance with the AIM rules they are not typically involved, nor do they necessarily have the relevant expertise, in reviewing the annual report as it is prepared. Whilst auditors focus on ensuring that reports comply with the minimum requirements there appears to be insufficient focus on ensuring that the report is of a high quality.

The quality of non-executives in this market segment varies and the appointment process often lacks transparency. Non-executives are frequently connected in some way to the company and the length of their tenure is of concern, with many staying on the board longer than the two terms common in larger organisations.

Most companies reported that they were satisfied with the level of support they received from their auditors but some felt their auditors erred on the side of caution when it came to observing their independence and to applying the materiality test. There was limited support for a relaxation in the independence requirements for auditors. There was more broad-based support for greater clarity around the boundary as their auditors were concerned that they may be challenged in this area from regulatory audit inspections which often made them very cautious when providing advice.

Companies and their auditors observed that extended auditor reporting has had a positive influence on reporting as it has resulted in companies becoming more engaged with their auditors on financial reporting matters and disclosure of risk.

4 Governance

4.1 Objectives and scope

The objective of this strand of the project was to assess the quality of corporate governance at the companies selected in order to assess whether weak governance was a potential factor in the quality of reporting.

4.2 Approach / methodology

We analysed governance indicators for a total of 60 smaller quoted companies with a market capitalisation below £100m and AIM companies with a market capitalisation between £5m and £658m. AIM companies outnumbered main market companies in our sample by roughly 8 to 1. The companies chosen were among those who either (i) received a substantive letter from CRR which was closed in the two years to 31 March 2014; or (ii) were one of the individual audits reviewed as part of the AQR thematic inspection.

The analysis looked at specific indicators of the quality of corporate governance, selected with reference to the UK Corporate Governance Code. The indicators chosen were:

(i) Separate Chair and CEO.
(ii) Minimum standards for number of independent non-executive directors (at least 2 plus the Chair).
(iii) Minimum standards for audit committee composition (at least 2 independent non-executive directors).

These indicators are assessed annually for FTSE 350 and smaller quoted companies by the Grant Thornton annual survey of compliance with the UK Corporate Governance Code. This provides a useful reference point when it comes to analysing the evidence gathered.

In addition, we reviewed:

- Whether there is a controlling shareholder.
- What proportion of shares directors hold.
- Whether the FD/CFO is on the board.

4.3 Findings

In our sample of companies we found that:

- 80% of companies had a separate Chair and CEO and of those that did not, all except one company are AIM companies;

- 52% met the minimum standards for the number of independent non-executive directors on the board; and

- the same 52% met the minimum standards for audit committee composition.

Overall 50% of our sample met all three of the selected corporate governance indicators. Of the companies that did not comply with all three indicators, all except one were AIM companies.

There was a majority shareholder at only three of the companies in our sample. However, 88% of companies had significant shareholders with 10% of outstanding equity and 43% had significant shareholders with 25% or more of outstanding equity. Directors held significant shareholdings at 52% of the companies in the sample. Companies listed on the main market were far more likely to have institutional investors as significant shareholders than companies quoted on AIM.

The finance director sits on the main board at 92% of the companies in our sample.

The above evidence indicates that while there is a high level of adherence to the principle of having a separate chair and CEO, 46% of the AIM companies in our sample do not comply with the other two key indicators of the quality of governance as set out in the UK Corporate Governance Code.

In terms of financial expertise on the board, it is encouraging that the finance director sits on the main board at 92% of our sample. We consider that, if this were supported by greater adherence to the principles in the UK Corporate Governance Code around board and audit committee composition, there should be a positive impact on the quality of corporate reporting by these companies.

We have also analysed the choice of auditor of the companies in our sample. 53% of our sample were audited by one of the big four audit firms. A further 42% were audited by the next five largest firms (Grant Thornton, BDO, Mazars, Baker Tilly and Crowe Clarke Whitehill); and the remaining 5% were audited by smaller audit firms. We consider that if these audit firms take up the recommendations in this report and apply appropriate procedures to smaller listed company audits this should also be a positive effect on the quality of their corporate reporting.

5 Preparer qualifications

5.1 Objectives and scope

The objective of this strand of the project was to consider the knowledge and experience of preparers of smaller quoted companies.

5.2 Approach / methodology

(i) AQR considered whether the auditors made any assessments of the knowledge/experience of preparers in relation to the sample of companies selected for review. They also tried to assess the quality of the drafts presented by management for audit but they were unable to do so, as the drafts were often not retained on the audit file.
(ii) The FRC reviewed the experience and qualifications of the finance directors (or equivalent) for a sample of 100 smaller quoted companies based on their profiles in the Annual reports of the relevant companies or other publically available source.
(iii) For the same sample, we considered the experience and qualifications of the audit committee Chair and other non-executives.
(iv) The questionnaire for preparers of smaller quoted companies included a question relating to the qualifications of staff in the finance function.

5.3 Findings

AQR review

The AQR review found that there was very little evidence that the auditors considered the competence or experience of the finance function to prepare the annual report.

Sample testing – qualifications of preparers

In the FRC's sample of companies 73% of companies had a finance director (or equivalent) who had disclosed a relevant professional accounting qualification. The survey of preparers of financial statements showed that from the 63 respondents, 94% stated that one or more of their finance department were professional accountants (the remaining 6% declined to respond specifically on relevant qualifications of its staff).

In relation to non-executive directors the sample indicated that 63% of companies had one or more non-executive with a relevant professional accounting qualification (48% of audit committee Chairs were qualified accountants).

Overall 89% of companies in the sample had one or more board member (either executive or non-executive) with a relevant professional accounting qualification.

The above analysis indicates that there are a high number of qualified accountants involved in the preparation of financial statements but a lesser proportion of non-executives with a relevant qualification. The FRC considers that financial statements should be prepared and reviewed by suitably experienced and qualified individuals. Whilst not a requirement of the listing rules or the AIM rules, companies are encouraged to ensure that financial statements are prepared and reviewed by staff with a recognised accounting qualification. Companies should also ensure that such qualified accountants have and maintain appropriate CPD.

The FCA's Disclosure and Transparency Rules require at least one member of the audit committee to have competence in accounting and/or auditing. The UK Corporate Governance has similar requirements. Discussions with stakeholders indicate that the tone at the top of the organisation is an important factor in improving the quality of financial statements. The FRC would therefore encourage companies to ensure that they have an appropriately qualified accountant on the audit committee, to ensure the committee can monitor and review the preparation of the financial statements and engage with the company's auditors on reporting matters and significant judgments.

In carrying out their work, auditors are required to consider whether the control environment of a company has an appropriate commitment to competence. The FRC therefore expects auditors to make an assessment of the strength of a company's finance function, communicate this to the audit committee and thereby encourage discussion on promoting improvements in the level of technical competence.

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