



Governance *in brief*

FRC publishes Discussion Paper on proposals to improve the quality of reporting by smaller listed and AIM-quoted companies

Headlines

- There is room for improvement in a number of key areas in the reporting of smaller quoted companies.
- In general at smaller quoted companies, the preparation of the annual report is seen as a compliance exercise rather an opportunity to provide relevant information to shareholders.
- Areas which investors find important, such as the description of the business model, accounting policies and judgements should receive more focus – these are areas where the FRC finds issues of quality at these companies.

Background

In July 2014 the FRC launched a project to better understand the challenges faced by smaller listed and AIM quoted companies ('smaller quoted companies') in order to evaluate and plan how it might assist them in addressing the quality of their reporting.

This Discussion Paper provides the results of the first phase of the project which focused on gathering and assessing evidence of the issues that smaller quoted companies face (including being attractive to investors), understanding the barriers to higher quality reporting and then exploring ways that the FRC might assist such companies to address the quality of their reporting with the overall aim of improving confidence in the integrity of their financial statements and of the markets as a whole.

What areas did the FRC find for improvement?

The annual report matters to investors, particularly the annual report of smaller quoted companies as these companies have fewer opportunities to engage with investors than their larger counterparts.

Investors in this segment have said that the areas they focus on most 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.

These are precisely the areas where the FRC finds smaller companies fall short.

What are the barriers to better quality reporting?

A number of barriers to better quality reporting by smaller quoted companies are highlighted in the Discussion Paper including:

A perceived lack of investor interest – the annual report for this market segment is particularly important in the absence of analysts' reports and the quality of reporting can impact investment, rating and lending decisions. Despite this, smaller companies still think that investors do not read their annual reports and hence see the preparation of the annual report as a compliance exercise rather than seeing it as an opportunity to provide relevant information to stakeholders.

Resource constraints – smaller quoted companies find preparing their annual reports quite a challenge. Such challenges might include a lack of skilled resources to prepare the report or a lack of up-to-date technical knowledge of current reporting requirements and standards.

Access to professional resources – smaller companies might have limited access to external financial reporting expertise.

The FRC notes that "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". In order to achieve the required changes to reporting quality, the FRC acknowledges that a number of stakeholders must play their part including; the finance function, those charged with governance and auditors.

The FRC proposals

The Discussion Paper provides a number of proposals, under three broad areas:

Reporting requirements and practices

There was no appetite from investors, auditors or companies for allowing AIM companies to report under UK GAAP as an alternative to IFRS. The view expressed was that AIM companies and listed companies should report under a single framework to allow consistency and comparability. The FRC highlighted that the use of boilerplate disclosure and the inclusion of information that is not material to the financial statements are both likely to deter investors. To encourage smaller listed and AIM-quoted companies to provide a more tailored annual report the FRC is planning to:

- consider whether the proposed EU 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;
- 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 are encountered 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 suggestions developed in the Lab that are tested with investors, so they can be put into practice.

Audit practices

Phase 1 of the project also considered whether Ethical Standards for Auditors "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". There was only "limited support" for any relaxation of the ethical standards for auditors but the FRC will consider, as part of its 2015 review of ethical standards, providing greater clarity for auditors on what is acceptable and what is not. The FRC will also review whether the process of granting of 'Responsible Individual' status (the process of granting individual auditors signing authority) could be improved to ensure that audit partners are suitably qualified and experienced to carry out audits of smaller quoted companies.

Company governance and resources

Engagement in the reporting process by those charged with governance is critical, particularly where there is a lack of skilled resources. To address the challenges faced by a lack of skilled resources the FRC will:

- discuss with the accountancy and audit professional bodies 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.

For further information

Financial Reporting Council

Improving the quality of reporting by smaller listed and AIM quoted companies (June 2015) – <https://www.frc.org.uk/Our-Work/Publications/FRC-Board/Consultation-Improving-the-Quality-of-Reporting-b.aspx>

Deloitte View

- We welcome and support the FRC's initiative to improve the quality of reporting by smaller quoted companies which is widely recognised as a challenge.
- The number of companies on UK public markets has reduced considerably in the last decade for a number of reasons – companies need to consider carefully the benefits as well as continuing obligations (and hence costs) of maintaining a listing.

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