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The Quoted
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Stephen Haddrill
Chief Executive
Financial Reporting Council
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4 April 2011

Dear Mr. Haddrill,

Financial Reporting Council – Effective Company Stewardship

INTRODUCTION

The Quoted Companies Alliance (QCA) is a not-for-profit membership organisation working for small and mid-cap quoted companies. Their individual market capitalisations tend to be below £500m.

The QCA is a founder member of European**Issuers**, which represents over 9,000 quoted companies in fourteen European countries.

The QCA Corporate Governance and Financial Reporting Committees have examined your proposals and advised on this response. A list of committee members is at Appendix A.

RESPONSE

We welcome the opportunity to respond to this consultation. The Quoted Companies Alliance seeks to encourage quality dialogue and constructive and active engagement between quoted company boards and their shareholders and so believe that taking steps to improve company stewardship is important.

We recommend that the FRC seeks to illustrate clearly how any changes it proposes would have helped matters leading up to the financial crisis, in particular with specific examples. In particular, where companies have failed, an analysis of the issues / weaknesses in their reporting would be helpful, so that an informed debate can be had to ensure that any changes to the existing regime are targeted and necessary.

Shareholder engagement

We believe that companies can be too focused on ‘ticking the boxes’ in the process of producing their annual reports, which results in reports that are overly complex and filled with immaterial information. At present, a significant proportion of the content in annual reports appears to be driven by compliance requirements rather than communicating with shareholders in a focused way. We therefore view that measures should concentrate on improving behaviours rather than adding more processes that could result in further boilerplate disclosure, and therefore less meaningful reports. Quality reporting will result primarily from companies focusing on transparent and material content and secondarily from compliance processes, driven by multiple, superfluous requirements.

In our view, the major element that is lacking from effective stewardship is effective engagement by shareholders. This engagement leads to quality shareholder relations and trust, without which we would expect to see continuing demands for increased regulation. If shareholders effectively engage with boards, directors will be motivated to improve their stewardship and the reporting of stewardship.

If the majority of shareholders continue to be disengaged, then corporate reporting, and quality controls around corporate reporting (e.g. auditors and audit committee), will remain peripheral to the activities of most key executives responsible for the performance of the business.

Therefore, we believe that effective company stewardship is in essence more of a behavioural issue than a regulatory issue, and would like to see the FRC actively pursue proposals that focus on addressing behaviours rather than just processes. In particular, it is interesting that the consultation paper cites primarily the financial crisis as the motivation for suggesting changes to the quality control of reports; however, there does not seem to be any mention of the demand from shareholders themselves for the proposals or recommendations outlined.

Proportionality for smaller quoted companies

We are disappointed and concerned that this discussion paper was developed with input from an advisory group that did not include adequate smaller company representation. Smaller quoted companies should be involved at an early stage in any project that considers reporting frameworks, as they account for 85% of all quoted companies and changes may have a significantly different cost / benefit analysis for them as compared to a larger company.

However, we do welcome the FRC's acknowledgement on page 5 of the paper that it seeks input on whether these proposals should apply to all listed companies or only a sub-set. We believe that the FRC needs to ensure that these proposals are proportionate and targeted so as not to stifle smaller quoted companies .We would be happy to work with the FRC to further refine these proposals.

Other initiatives

As you will no doubt be aware, it is essential to consider any proposals in the wider context of on-going consultations on changes to corporate reporting, including the Department of Business, Innovation and Skills' (BIS) consultation on narrative reporting, the European Commission's Audit Green Paper and the European Commission's upcoming green paper on corporate governance. Any recommendations should be "joined up" to avoid any duplication of requirements on companies and to ensure that the objective of improved corporate reporting is achieved.

Comments on the Key Recommendations

1. **Directors should take full responsibility for ensuring that an Annual Report, viewed as a whole, provides a fair and balanced report on their stewardship of the business.**

We agree that companies should "communicate high quality and relevant narrative and financial information to the market". However, we view that this is an existing requirement in the business review and financial statements, so careful consideration should be given before adding to or duplicating what is already in place.

In terms of directors taking full responsibility for the Annual Report and ensuring that it is "fair and balanced", we do not necessarily believe that this will lead to improved reporting.

We have the following concerns:

- introducing the new terminology of "fair and balanced" may result in a significant amount of work to determine what it means and what steps a company must take to satisfy those requirements; and

- the opaqueness of this terminology may lead to companies including more immaterial disclosures and using less transparent language, which does not promote coherent and quality reporting.

Business activities vary so considerably that a narrative reporting standard produced by the ASB can only be very high level and will not be able to act as a driver for improvements in quality. It is questionable whether such a standard will be able to improve upon current best practice.

As we state above, we believe that shareholders should be the driver for improved reporting as they will tailor their requirements to the particular circumstances of the business. We believe the FRC should focus on finding solutions to the key issue of this lack of engagement, encouraging shareholders to play their stewardship role.

2. Directors should describe in more detail the steps that they take to ensure:

- **the reliability of the information on which the management of a company, and therefore directors' stewardship of the company, is based; and**

- **transparency about the activities of the business and any associated risks.**

We are concerned that this further disclosure could add more boilerplate and we would prefer that the Annual Report is transparent about the activities of the business and associated risks as a whole.

We also note that the justification for this recommendation is based on large businesses where directors are divorced from the day-to-day activities and "it is not possible for senior management of larger companies to have a personal knowledge of all the activities of their business". This is not the situation in many smaller quoted companies and so we would note that this may be one area where a targeted and proportionate approach should be adopted. Again, the QCA would be pleased to assist the FRC in developing such an approach.

3. The growing strength of Audit Committees in holding management and auditors to account should be reinforced by greater transparency through:

- **fuller reports by Audit Committees explaining, in particular, how they discharged their responsibilities for the integrity of the Annual Report and other aspects of their remit (such as their oversight of the external audit process and appointment of external auditors); and**

- **an expanded audit report that:**

    - **includes a separate new section on the completeness and reasonableness of the Audit Committee report; and**

    - **identifies any matters in the Annual Report that the auditors believe are incorrect or inconsistent with the information contained in the financial statements or obtained in the course of their audit.**

Audit Committee Reports

We support this proposal. The inclusion of fuller Audit Committee reports is already considered best practice; for example, in the Quoted Companies Alliance's *Audit Committee Guide for Smaller Quoted Companies*, we recommend companies produce fuller Audit Committee reports as outlined in the proposals.

Expanded Audit Reports

We are not convinced that an expanded audit report will result in improved behaviours and better reporting.

Auditors are already required to report on any information within the scope of the Annual Report that they believe to be inconsistent with that which they have learned through the audit process. This requires the auditor to review the narrative reporting and we believe that this strikes an appropriate balance.

In general, although auditors already review the information, we believe that requiring auditors to include an additional assurance statement will lead to increased audit costs for companies, as audit firms will be obliged to engage in more due diligence, requiring more time and meetings with management to discuss areas of contention.

In particular, we believe that additional checks for items that are incorrect in the narrative content would result in increased work, as:

- auditors would potentially have to call on others with expertise in subjects included in narrative reports (e.g. environmental and social factors); and
- the judgement around narrative reporting is much more of a qualitative assessment, and as such, will require more auditor and management time to agree on areas of contention. As stated above it would be difficult to provide narrative reporting standards that are broad enough to account for the vast differences between companies and also be specific enough to provide auditors with something to judge 'correctness', while not resulting in more boilerplate and immaterial information in the Annual Report.

Notwithstanding the above, if the FRC wishes to proceed with this proposal, it should not do so without developing and consulting on adequate guidance and the definition of the scope of this work.

Overall, we believe that the FRC needs to consider the costs (to companies) / benefit (to users of the accounts) analysis of its proposals in this area. As above, we would support an initiative to target shareholder engagement, rather than potentially adding more process and less meaningful disclosures to the Annual Report.

4. **Companies should take advantage of technological developments to increase the accessibility of the Annual Report and its components. Access to the information in Annual Reports would be improved if companies were to:**

- **provide access to Annual Reports and accounts through the web in a form that enables them to be searched quickly and easily;**
- **adopt common reporting languages such as XBRL if that would facilitate engagement; and**
- **be relieved of the burden of producing Annual Reports and accounts in printed form which is a drain on the resources they have for developing better methods.**

We support increasing opportunities to make better use of technology, but a proper cost/benefit assessment should be made before requiring such changes.

Most companies already provide access to their accounts on their website, which allows the user to search for information more easily than in paper form.

If the FRC wishes to recommend use of XBRL, as part of its cost / benefit analysis it should clarify how it believes this would facilitate shareholder engagement as a benefit. We believe that XBRL could provide a useful platform for users in terms of providing high-level comparisons; however the benefits are completely dependent on how this requirement is mandated, implemented and taken-up by users (in particular, shareholders). In terms of costs, these would need to be clearly outlined and compared with benefits to both the users and companies. If the FRC moves forward with its proposals, there should be an initiative to assist and guide smaller companies on how to make the necessary changes.

Our members have provided feedback that the burden in producing reports is largely in their production and drafting rather than in their printing, which for smaller companies creates a peak in their workload. To reduce the burden of reporting, we would suggest that the FRC consider ways in which this workload could be better spread. For example, if reporting was made via a website, then it should be possible for different parts to be updated on a different time schedule.

5. **There should be greater investor involvement in the process by which auditors are appointed.**

While this is arguably desirable, we do not believe that this is practical if all shareholders are to be treated fairly and given representation. In particular we believe that any report on the process by which an audit committee selected an auditor will quickly degenerate into boilerplate.

We consider that auditor independence is best handled as an ethical matter for auditors, subject to review by the audit committee and disclosure.

6. **The FRC's responsibilities should be developed to enable it to support and oversee the effective implementation of its proposals.**

We are supportive of an extension of the FRRP's responsibilities to cover those parts of the Annual Report required by law (and covered by safe harbour provisions). However, we do not want to see an extension of the FRRP's responsibilities to cover additional voluntary sections in the Annual Report, as we see practical difficulties in doing this given the subjective nature of some of the content, and the vast amount of expertise required to evaluate all the narrative.

We are concerned about the behavioural changes that might arise as unintended consequences of an extension of the AIU's supervision to the auditor's consideration of the narrative content of the Annual Report. This could lead to auditors requesting companies to provide support for the narrative sections, leading to a de facto audit of such sections, requiring a full verification exercise on those sections. Ultimately we are concerned that those sections will become uninformative and generalised.

7. **The FRC should establish a market participants group to advise it on market developments and international initiatives in the area of corporate reporting and the role of assurance and on promoting best practice.**

It is not clear how a market participants group would avoid overlap with existing FRC bodies such as the AIU, FRRP, ASB and the FRC's own corporate governance committee. If the FRC were to set up such a group, it should ensure that there is adequate representation of smaller quoted companies on the group.

Additionally, we would be very supportive of a "financial reporting" lab as a means to test out new reporting models and allow for innovation. The QCA Financial Reporting Committee's current initiatives include a project to explore the use of materiality to improve corporate reporting and reduce complexity (please see the QCA Corporate Reporting Charter attached for more on this).

If you would like to discuss any issues further, we would be pleased to attend a meeting.

Yours sincerely,

Tim Ward
Chief Executive

APPENDIX A

QCA CORPORATE GOVERNANCE COMMITTEE

Tim Goodman (Chairman)	-	Hermes Equity Ownership Services Ltd
Edward Beale	-	City Group plc
Tim Bird/Edward Craft	-	Wedlake Bell LLP
Nigel Burton	-	Petrosaudi Oil Services
Anthony Carey	-	Mazars LLP
Louis Cooper	-	Crowe Clark Whitehill LLP
Madeleine Cordes	-	Capita Registrars Ltd
Kate Elsdon	-	PricewaterhouseCoopers LLP
Clive Garston	-	Davies Arnold Cooper LLP
Nick Graves	-	Burges Salmon LLP
Eugenia Jackson	-	F & C Asset Management
Colin Jones	-	UHY Hacker Young
Dalia Joseph	-	Oriel Securities
Derek Marsh	-	China Food Company PLC
Georgina Marshall	-	Aviva Investors
James Parkes	-	CMS Cameron McKenna LLP
Nick Teunon	-	FTSE
Cliff Weight	-	MM & K Ltd
Andrew Viner	-	BDO LLP
Melanie Wadsworth	-	Faegre & Benson LLP
Tim Ward	-	The Quoted Companies Alliance
Kate Jalbert	-	The Quoted Companies Alliance

THE QUOTED COMPANIES ALLIANCE FINANCIAL REPORTING COMMITTEE

Anthony Carey (Chairman)	-	Mazars LLP
Anthony Appleton/Nicole Kissun	-	PKF LLP
Peter Chidgey	-	BDO LLP
Sarah Cox	-	Ernst & Young LLP

Ian Davies	-	Victoria plc
David Gray	-	DHG Management
Kern Roberts	-	Smith & Williamson
Chris Smith	-	Grant Thornton LLP
Ian Smith	-	Deloitte LLP
Matthew Stallabrass	-	Crowe Clark Whitehill LLP
Paul Watts/Bill Farren	-	Baker Tilly
Nick Winters/James Lole	-	RSM Tenon Group PLC
Colin Wright	-	UHY Hacker Young
Tim Ward	-	The Quoted Companies Alliance
Kate Jalbert	-	The Quoted Companies Alliance

APPENDIX B

THE QUOTED COMPANIES ALLIANCE (QCA)

A not-for-profit organisation funded by its membership, the QCA represents the interests of small and mid-cap quoted companies, their advisors and investors. It was founded in 1992, originally known as CISCO.

The QCA is governed by an elected Executive Committee, and undertakes its work through a number of highly focussed, multi-disciplinary committees and working groups of members who concentrate on specific areas of concern, in particular:

- taxation
- legislation affecting small and mid-cap quoted companies
- corporate governance
- employee share schemes
- trading, settlement and custody of shares
- structure and regulation of stock markets for small and mid-cap quoted companies; Financial Services Authority (FSA) consultations
- political liaison – briefing and influencing Westminster and Whitehall, the City and Brussels
- accounting standards proposals from various standard-setters

The QCA is a founder member of European**Issuers**, which represents quoted companies in fourteen European countries.

QCA's Aims and Objectives

The QCA works for small and mid-cap quoted companies in the United Kingdom and Europe to promote and maintain vibrant, healthy and liquid capital markets. Its principal objectives are:

Lobbying the Government, Brussels and other regulators to reduce the costing and time consuming burden of regulation, which falls disproportionately on smaller quoted companies

Promoting the smaller quoted company sector and taking steps to increase investor interest and improve shareholder liquidity for companies in it.

Educating companies in the sector about best practice in areas such as corporate governance and investor relations.

Providing a forum for small and mid-cap quoted company directors to network and discuss solutions to topical issues with their peer group, sector professionals and influential City figures.

Small and mid-cap quoted companies' contribute considerably to the UK economy:

- There are approximately 2,000 small and mid-cap quoted companies
- They represent around 85% of all quoted companies in the UK
- They employ approximately 1 million people, representing around 4% of total private sector employment
- Every 5% growth in the small and mid-cap quoted company sector could reduce UK unemployment by a further 50,000
- They generate:
    - corporation tax payable of £560 million per annum
    - income tax paid of £3 billion per annum
    - social security paid (employers' NIC) of £3 billion per annum
    - employees' national insurance contribution paid of £2 billion per annum

The tax figures <u>exclude</u> business rates, VAT and other indirect taxes.