



Smaller Listed and AIM Quoted Companies

A PRACTICAL GUIDE FOR AUDIT COMMITTEES
ON IMPROVING FINANCIAL REPORTING

A joint publication from the Financial Reporting Council ("FRC") and the Institute of Chartered Accountants in England and Wales ("ICAEW").

This guide offers practical suggestions for audit committees and boards of smaller listed and AIM quoted companies seeking to deliver high quality financial and risk reporting.

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Executive summary

SMALLER QUOTED COMPANY PRACTICAL GUIDE TO IMPROVING FINANCIAL REPORTING

Audit committees can play a pivotal role in driving up the quality of financial reporting by promoting a culture of improvement. This can be achieved, in part, by asking the right questions at the right time. Below we summarise some suggested questions (found within the guide) that can help the audit committee of a smaller quoted company bring about a step change in the quality of its financial reporting.



Figure 1 The Financial Reporting Cycle.

PLANNING	
<p>Questions for the audit committee to consider</p> <ul style="list-style-type: none"> • What lessons can we learn from last year’s financial reporting process? • What action has been taken to ensure that the key financial reporting issues during last year’s audit are less of a challenge this year? • Have there been any financial reporting standard changes during the year? • Will there need to be any changes to our key accounting policies? • Have our systems been adapted to take account of any changes? • What are the company’s key financial reporting risks for this year? • Are there any unusual transactions or areas of significant judgement that will affect the preparation of the annual report and 	<p>accounts? What action has been taken to manage risks of misstatement that may arise from these?</p> <ul style="list-style-type: none"> • How have the CFO and finance team addressed the points in the FRC’s year-end letter and matters previously raised by the auditor? <p>Questions to ask the external auditor</p> <ul style="list-style-type: none"> • Can you explain the rationale for the audit plan and timetable? • What is your view of the finance process and function? • What are the key audit risks this year and how do these impact on financial reporting? • What financial disclosures are critical in connection with the key audit risks and why?

PRODUCTION OF INTERIM AND ANNUAL REPORTS

Questions to ask the external auditor during the audit

- What is the attitude and level of commitment of management to financial reporting?
- Are there any unidentified risks we should be articulating in the annual report?

Questions to ask the external auditor at the audit completion meeting

- Have you noticed any changes in the quality of the company's financial reporting?
- What can be done to make the financial reporting process more effective?
- What three things should the company do differently?

REVIEW PERFORMANCE

Questions to ask the external auditor at a private meeting

- Does management generally address issues raised during the audit?
- What aspects of the financial statements and associated notes need improving?
- Have these issues been identified previously?
- Have you discussed your views with the CFO and other executive directors?
- How do we compare in this area to other companies of a similar size?



FORMULATE ACTION PLAN FOR NEXT YEAR

Questions for the audit committee to consider

- What information are current and future investors likely to be interested in? Are there gaps in the current information the company communicates?
- What financial and non-financial information and reports are used for internal management purposes, and how does this information compare to the scope and content of our external reporting?
- How do we ensure that the company is complying with its reporting obligations?
- How does the audit committee ensure that it is up to date with the latest reporting requirements?

Questions to ask the CFO and finance team

- What level and type of resourcing does the finance team need, have any gaps been identified and how can they be filled?
- What knowledge, including financial and other relevant qualifications, and experience do members of the finance team and board bring?
- How do we ensure that the finance team comply with continuing professional development (CPD) requirements? Is this documented and reviewed?
- Is complying with CPD requirements a key performance indicator within the organisation's appraisal system?
- How are knowledge gaps and training needs identified and addressed?
- When does planning for the year end begin? What factors drive this decision and could the timing be improved?
- Was there a clear timetable for last year's financial reporting process? Was it realistic and was it met?
- What are the key deadlines for this year? Where are the pressure points and how will we manage this?
- How will we gather and collate the data needed to comply with new standards and regulations?
- How do we ensure that financial reporting systems continue to be robust and fit for purpose as the company grows?
- What process is in place to identify errors and inconsistencies in the annual report, for example, between narrative sections and the financial statements?

Introduction

The core purpose of the UK financial reporting regime¹ is to ensure that the information needs of investors and other users are met. The requirement for compliance with relevant reporting frameworks and regulation helps users to assess the financial integrity of a company and hold management to account. More than this, high quality financial reporting contributes to a strong and efficient economy by improving trust, transparency and liquidity, thereby lowering the cost of capital.²

In its capacity as a provider of independent governance over the annual corporate reporting process, the audit committee plays a crucial role in driving quality. It oversees the integrity of the financial statements and related reporting prepared by management and it manages the company's relationship with the external auditors for the benefit of shareholders and other stakeholders. Including an audit committee report within the annual report can also offer important insights for investors, thereby strengthening trust in the financial reporting process.

The FRC's discussion paper in 2015, 'Improving the Quality of Reporting by Smaller Listed and AIM Quoted Companies'^{3&4} found that:

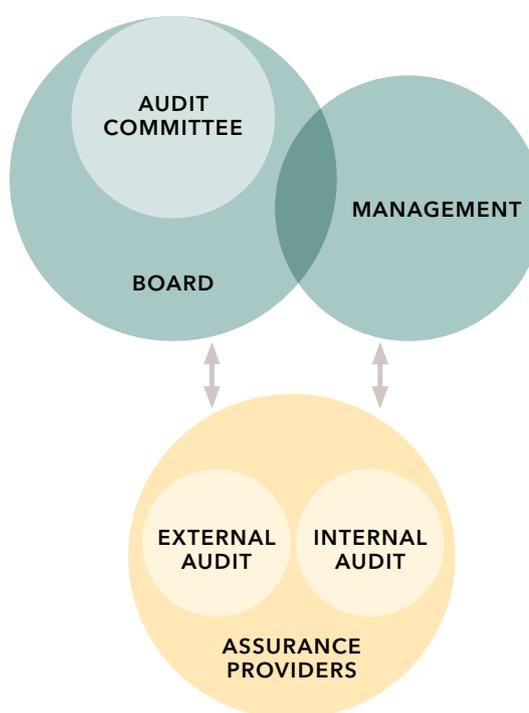
'whilst the system of financial reporting is not fundamentally flawed, there is a higher incidence of poorer quality annual reports by smaller quoted companies than by their larger counterparts.'

The FRC discovered that financial reporting is not always seen as a top-tier issue by smaller quoted companies. It also found that smaller quoted companies are not always up to date with the most recent reporting requirements. Thus, they may not appreciate the full extent of the accounting considerations that need to be applied to their reporting of potentially complex transactions. The discussion paper proposed a number of initiatives to support improvement in the quality of reporting by smaller companies.

The board, and the audit committee in particular, have an important role to play in improving the reporting process and driving higher quality in financial reporting. This can be achieved by developing productive relationships with management, particularly the CFO and the finance function, and with both internal and external auditors, as set out in figure 2.

Figure 2

THE AUDIT COMMITTEE: KEY RELATIONSHIPS



QCA Audit Committee Guide. Link: <https://bit.ly/2Dx7xAP>

Further information on the specific role and responsibilities of the audit committee can be found in the UK Corporate Governance Code, the Quoted Companies Alliance's (QCA) Corporate Governance Code and associated guidance material. Links to these resources can be found in the 'Useful Resources' section at the back of this guide.

RECENT DEVELOPMENTS

In the four years since the FRC published its discussion paper, a number of regulatory developments have altered the landscape for financial reporting by smaller quoted companies, presenting new challenges for those responsible.

¹ Financial reporting: who does what? (ICAEW 2019) Link: <https://bit.ly/2DCst9P>

² Growth, development and accounting: seeing the bigger picture (ICAEW 2017) Link: <https://bit.ly/2XPL9e0>

³ Improving the Quality of Reporting by Smaller Listed and AIM Quoted Companies (FRC 2015) Link: <https://bit.ly/2V19Gzu>

⁴ For the purposes of this report, we have in mind companies listed on the main market with a market capitalisation of between £20m and £100m and UK companies quoted on the Alternative Investment Market (AIM) with a market capitalisation greater than £5m.

These developments reinforce the need for effective engagement by the audit committee in the financial reporting process. This involvement is particularly important given the effects of the Markets in Financial Instruments Directive II (MIFID II), which is expected to lead to a fall in the number of broking houses and analysts publishing research on mid and small-cap companies. The QCA/Peel Hunt Mid and Small-Cap Investor survey published in April 2018 found that fund managers are already noticing a decrease in research and expect this to continue.⁵ Investors are likely to place increasing reliance on the annual report and accounts in the absence of other sources of information.

In addition, the publication of the Competition and Markets Authority's Report into the audit market in April 2019⁶ – which set out proposals for enhanced regulatory scrutiny of audit committees in relation to the year-end accounts and audit process – is a sign that the quality of financial reporting and the role of audit committees are likely to remain under the spotlight for the foreseeable future. Other relevant developments are described in Figure 3.

Figure 3

Corporate governance: with effect from September 2018, the London Stock Exchange requires each AIM company to report which 'recognised' corporate governance code it has applied. While there is flexibility over which code is adopted, both the QCA Code and the UK Corporate Governance Code emphasise directors' duties and responsibilities for financial reporting. This is intended to ensure that financial reporting is seen as a priority by the board and its audit committee.

FRC thematic review: in November 2018, the FRC published the results of its thematic review on reporting by smaller listed and AIM quoted companies.⁷ The aim of the review was 'to assess the extent of any improvement in the general quality of compliance' by smaller companies since the publication of the FRC's 2015 discussion paper and the implementation of its proposals. The review focused on specific aspects of financial reporting with reference to the priority areas identified in that paper.⁸

While the review highlighted where there was still scope for improvement, there were also promising signs that progress is being made.

'The better practice examples identified by the thematic review indicate that smaller companies are able to provide high quality information to stakeholders.'

Paul George, FRC Executive Director, Corporate Governance and Reporting.

New standards: in the last few years, three new international accounting standards, on revenue (IFRS 15), leases (IFRS 16) and financial instruments (IFRS 9), have come into effect. A significant effort continues to be required by many companies to adapt their systems and reporting processes to meet the requirements of these major new standards.

New regulations: amended regulations and guidance covering the Strategic Report requirements place greater emphasis on the duties of directors under section 172 of the Companies Act 2006 to promote the success of the company for the benefit of shareholders. The Strategic Report must now include a statement describing how this duty has been fulfilled, taking account of the consequences of any decision in the long term, the interests of the company's employees, suppliers, customers, wider stakeholders, and the impact of the company's activities on the community and environment.

These changes, which came into effect for large companies for financial periods beginning on or after 1 January 2019,⁹ will place even greater emphasis on the importance of providing high-quality information in the annual report.

⁵ The New World of MIFID II. Unintended Consequences. The QCA/Peel Hunt Mid and Small-Cap Investor survey. (QCA 2018)
Link: <https://bit.ly/2LgvwHc>

⁶ Statutory audit services market study (CMA). Final Report. 18 April 2019
Link: <https://bit.ly/2L3Ws0n>

⁷ FRC's thematic review findings. Link: <https://bit.ly/2AT1Lsn>

⁸ Topics included alternative performance measures (APMs), pension disclosures, accounting policies including critical judgements and estimates, cash flow statements and tax disclosures.

⁹ To meet the definition of 'large', a company must meet two of the following three criteria: turnover over £36m; balance sheet total of over £18m; 250 or more employees.

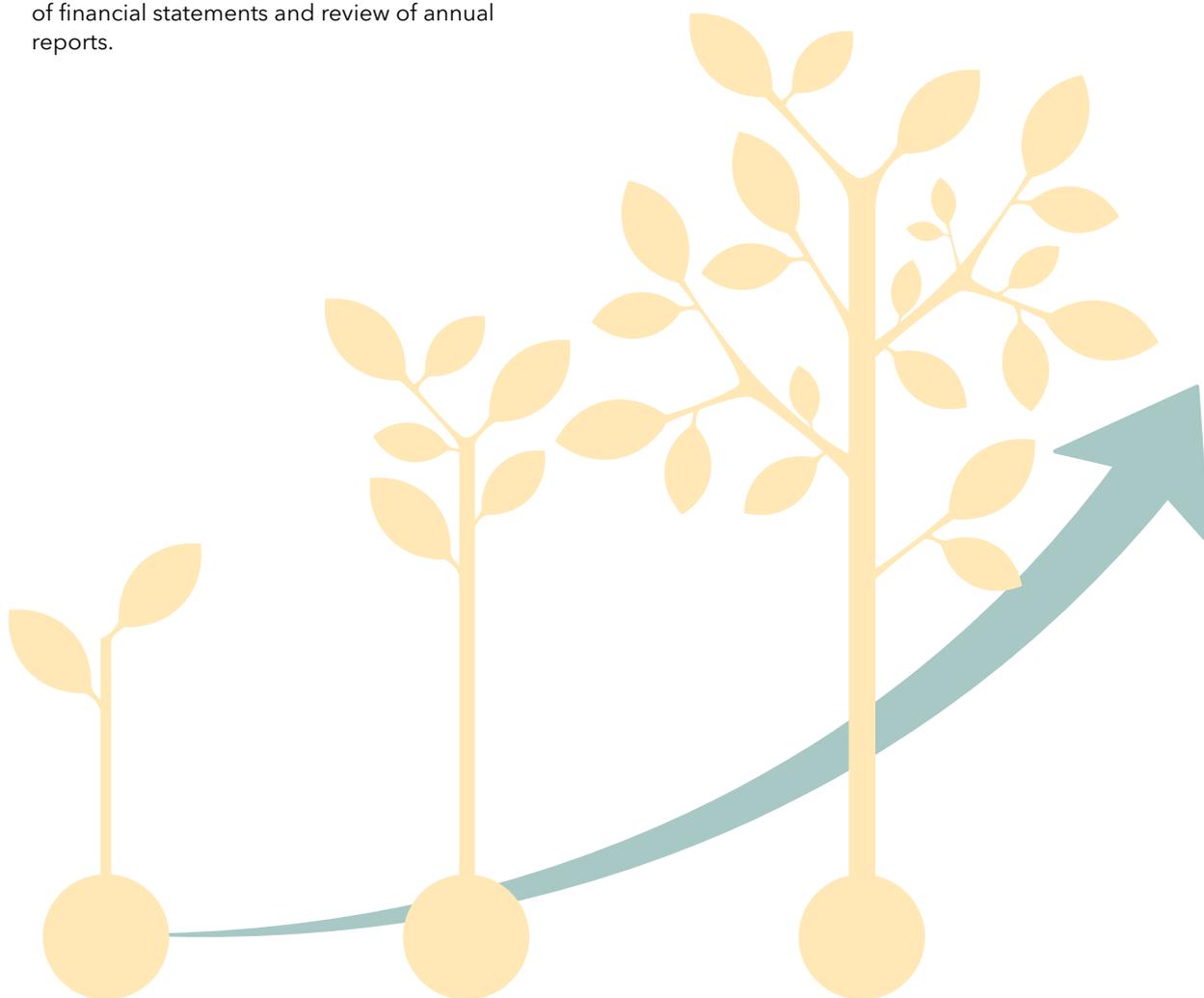
Improving the Quality of Reporting: Practical Guidance

This guide offers practical suggestions for audit committees and boards of smaller listed and AIM quoted companies⁴ seeking to deliver high quality financial and non-financial reporting to the users of the annual report and accounts. It builds on key themes that emerged from the FRC's 2015 discussion paper, which identified four areas where sharper focus could help companies improve the quality of their annual report and accounts. These areas are:

- 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 auditor in the audit of financial statements and review of annual reports.

This guide outlines practical tips and questions audit committees can consider asking as a way to challenge management on current financial reporting practices.

Our suggestions are not mandatory or prescriptive, and the guide is not a comprehensive list of all audit committee responsibilities. It aims to encourage good practice and to help audit committees and boards evaluate the adequacy of a company's financial reporting function and processes and drive improvements in quality.



UNDERSTANDING THE IMPORTANCE OF HIGH-QUALITY FINANCIAL AND NON-FINANCIAL REPORTING

Ensuring a company complies with financial reporting requirements is an essential task for management, with serious consequences for non-compliance in the form of penalties and potential reputational damage. A concerted effort, including the commitment of resources, is required to ensure full compliance with reporting obligations, including the relevant requirements of the UK Listing Authority or AIM Rules.

It is therefore important for the audit committee, in overseeing the financial reporting process, to have an understanding of the company's reasons for listing, its shareholder base and how the company intends to raise finance in the future. Collectively, these factors will influence how financial reporting is perceived within the company and allow the audit committee to recognise where there may be challenges in persuading management to prioritise high-quality financial reporting.

Questions for the audit committee to consider

- What information are current and future investors likely to be interested in? Are there gaps in the current information the company communicates?
- What financial and non-financial information and reports are used for internal management purposes, and how does this information compare to the scope and content of external reporting?
- How do we ensure that the company is complying with its reporting obligations?

NURTURING A CULTURE OF IMPROVEMENT

Audit committees have responsibility for overseeing the integrity, compliance and quality of the financial statements and disclosures prepared by management. They should help to ensure that financial reporting is prioritised within the company. This can be achieved by:

- nurturing a culture of improvement;
- encouraging better understanding throughout the company of the importance of financial reporting; and
- challenging current practices where they appear to fall short of expectations.

'The audit committee provides confidence to shareholders on the integrity of the financial results of the company expressed in the annual report and accounts and other relevant public announcements of the company. The audit committee should challenge both the external auditors and the management of the company.'

QCA Corporate Governance Code 2018

The FRC's 2015 discussion paper identified audit committee engagement as an area for improvement, reporting that, '52% of respondents to our survey of finance directors indicated that the audit committee or board provides only limited challenge to the annual report and financial statements'.

Knowing how to start to bring about change can be the biggest obstacle in driving up the quality of financial reporting. However, it will rarely be the case that it is necessary to overhaul all processes and procedures and so financial reporting changes should be viewed as part of a drive for continuous improvement. Below are some simple, practical steps that may help accelerate this journey.



Practical Tips

- Read the FRC's Annual Review of Corporate Reporting, published every October, which is a good starting point for audit committees wanting to improve the financial reporting process. The review sets out areas of reporting that the FRC has identified (through its monitoring activities) to have the greatest scope for improvement. The report includes an open letter to audit committee chairs and finance directors, which focuses on key areas for improvement and other topical and significant issues that should be addressed for the next annual reporting cycle.
- Focus on the generic areas of reporting that are a particular focus for investors in smaller quoted companies. The FRC's 2015 discussion paper identified these areas 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; and
 - provisions – both new provisions and those released during the year.
- Refer to concerns identified during the prior year's financial reporting process as a way to initiate change. Each concern should be revisited to understand the steps that have been taken to mitigate them in the current year. If no such steps have been taken, the audit committee will need to understand why not and act accordingly to ensure the concerns are addressed in a timely manner.
- Engage early in the financial reporting and auditing process to set the right tone from the top and demonstrate the company's commitment to high quality financial reporting. This engagement should begin at the audit planning meeting.
- Consider carrying out a good practice review, a service provided by most accounting firms. Note that selection of an advisor should be done carefully, to ensure that it does not

threaten auditor independence. The scope of these services extends beyond a compliance review and includes benchmarking against best practice. Such a review could not only identify areas for improvement, but also help to shift the perspectives of anyone within the company who views financial reporting solely as a compliance exercise. The FRC's 2018 thematic review on reporting by smaller listed and AIM quoted companies – which includes examples of best practice – can also assist here.

Questions for the audit committee to consider when planning the reporting cycle

- What lessons can we learn from last year's financial reporting process?
- What action has been taken to ensure the key financial reporting issues during last year's audit are less of a challenge this year?
- Have there been any financial reporting standard changes during the year?
- Will there need to be any changes to our key accounting policies?
- Have our systems been adapted to take account of any changes?
- What are the company's key financial reporting risks for this year?
- Are there any unusual transactions or areas of significant judgement that will affect the preparation of the annual report and accounts? What action has been taken to manage risks of misstatement that may arise from these?
- How have the CFO and finance team addressed the points in the FRC's year-end letter and matters previously raised by the auditor?

TIMING AND PLANNING

Careful planning, including consideration of key deadlines and other timing issues, is essential to an efficient financial reporting process.

The adequacy of appropriate resources to prepare the annual report can be a significant challenge, which can lead to preparation being late. This can have an adverse effect on quality by putting both the finance function and auditors under pressure to finalise the annual report in a short space of time. This can lead to a lack of sufficient care in the preparation of the financial statements, resulting in inconsistencies and other small errors, as well as more significant shortcomings in reporting.

The audit committee can help ensure that due consideration is given to the timing and scheduling of the financial reporting processes, including prioritisation of tasks which will ease the pressure on resources at the year-end. Early engagement in the planning process by the audit committee is essential, demonstrating the company's commitment to high-quality financial reporting and embedding this message within the company.



Practical Tips

- Produce a schedule of meetings as soon as the prior year financial statements have been signed off to ensure that key deadlines are met and the current year process runs smoothly. The QCA's Audit Committee Guide 2014,¹⁰ aimed at audit committees of small and mid-size quoted companies, provides useful advice. This includes a suggested schedule of meetings and itemises what should be discussed at each meeting throughout the year.
- Encourage colleagues to begin the process of writing the narrative sections of the annual report before the year-end to alleviate pressure on the finance team and auditors at the year-end. This will also allow more time to consider how to improve the explanation of matters such as the business model, principal risks and uncertainties, accounting judgements and accounting policies – all identified as areas of key interest to investors in smaller quoted companies.
- Request that the audit committee is sent the first draft of the financial statements, in addition to later versions. While some of the information will change in subsequent drafts, this will allow more

time for the audit committee to raise queries and have them resolved. This, in turn, should help reduce the pressure on resources towards the end of the process.

- As the audit progresses, review the timing of audit committee meetings to ensure there is enough time for points to be actioned before the next board meeting.

Questions for the audit committee to ask the CFO and finance team at the start of the financial year

- When does planning for the year-end begin? What factors drive this decision and could the timing be improved?
- Was there a clear timetable for last year's financial reporting process? Was it realistic and was it met?
- What are the key deadlines for this year? Where are the pressure points and how will we manage this?
- How will we gather and collate the data needed to comply with new standards and regulations?
- How do we ensure that financial reporting systems continue to be robust and fit for purpose as the company grows?
- What process is in place to identify errors and inconsistencies in the annual report, for example, between narrative sections and the financial statements?

SKILLSET AND EXPERIENCE

Many smaller quoted companies face a significant challenge when preparing the annual report due to the inadequacy of resources. This may include the size of the finance team and a possible lack of appropriate and necessary skills and knowledge to address all the reporting issues. The effect is intensified at the year-end when the finance team is under time pressure. Planning early is key.

Being dependent on one individual, or a small number of people, with financial reporting experience is a risk to the company. This is particularly relevant when the company faces implementing major new international accounting

¹⁰ Inspiring Trust. Audit Committee Guide for Small and Mid-size Quoted Companies. Link: <https://bit.ly/2Dx7xAP>

standards and changes to reporting regulations. While the audit committee is most closely involved, boards are also encouraged to engage actively in the financial reporting process; and to ensure that the finance function needs to be adequately resourced by those with the required knowledge and skill set.



Practical Tips

- Consider whether the audit committee and board are composed of individuals with the range of experience and skills, beyond financial expertise, necessary to oversee the production of the annual report and accounts.
- Assess the adequacy of resources in the finance team. Where additional permanent employees cannot be justified, consider whether additional temporary resources should be hired at the year-end to support the financial reporting process.
- Gauge whether there are gaps in the skillsets and expertise of the finance team. Key finance staff should keep up to date with current technical topics and regulatory changes by attending relevant courses.
- Make use of guidance available from the FRC, ICAEW and others. A list of some relevant resources is provided at the end of this guide.
- Members of the audit committee and board should also be given technical training so they can effectively challenge the finance team on financial reporting matters.
- Consider whether external expertise is required to help prepare the annual report. For example, share-based payment and directors' remuneration reporting were identified in the FRC's 2015 discussion paper as the areas that directors found most challenging.
- Engage regularly with the CFO outside of formal meetings to ensure that any financial reporting issues are raised and addressed in a timely manner.

Questions on level of skills and experience for the audit committee to consider with the CFO and finance team

- What level and type of resourcing does the finance team need at different times of the year, have any gaps been identified, and how can those be filled?
- What knowledge, including financial and other relevant qualifications, and experience do members of the finance team and board bring?
- How do we ensure that the finance team comply with continuing professional development (CPD) requirements? Is this documented and reviewed?
- Is complying with CPD requirements a key performance indicator within the company's appraisal system?
- How are knowledge gaps and training needs identified and addressed?
- How does the audit committee ensure that it is up to date with the latest reporting requirements?

USING THE AUDITORS WISELY

While the auditor's independence is critical to giving an unbiased opinion on the financial statements, this should not inhibit engagement between the audit committee and the auditor. Responsibility for accounting treatment lies squarely with management, as does the preparation of the accounts. However, auditors can provide support on the possible options presented by management and help the company reach sound decisions to reinforce the quality of its reporting.

The auditor has a responsibility to obtain sufficient and appropriate audit evidence on which to base the audit opinion. The audit committee, on the other hand, has responsibility for the oversight of the external audit function, which includes assessing the effectiveness of the audit process, and challenge by the auditor. The audit committee

should therefore discuss and challenge the auditor on the audit plan, including the appropriateness of timescales, and its approach to evidence.

The audit committee must strike the right balance between engaging with the auditor for support and engaging to challenge the audit process.

As part of its discussion with the auditor, the audit committee should understand whether the auditor's identification of risks, as articulated in the audit plan, has a significant impact on the entity's financial and risk reporting. Where this is the case, the audit committee should explore how these matters might affect the needs of investors and other users of the annual report.

The auditor is also uniquely placed to help the audit committee identify gaps in skills and resources within the finance team. The audit committee should make sure that it is soliciting input from the auditor in these areas to aid its evaluation.



Practical Tips

- Arrange regular contact with the external auditor throughout the year to ensure issues are dealt with promptly. For example, if a major transaction is about to be undertaken, the auditor will be able to discuss the possible options for the accounting treatment and give advice on where to find further guidance. Care must be taken to ensure that the auditor does not breach ethical standards in the course of considering such matters; the auditor should not play any part in the management or decision-making of an audit client.
- Seek early discussions about one-off transactions and areas of significant judgement to reduce timing issues at the year-end.
- Request a private session with the auditor without management present after the audit is complete. If deemed appropriate, consider holding such meetings during the audit as well. Use this as an opportunity to discuss openly any matters and concerns that might not have been discussed with executive management present. Ask the auditor to provide feedback and observations on the quality and adequacy of the finance process and function. The auditor will also be able to offer insights into the relationship, and level of cooperation, between management, internal audit and themselves.

Questions for the audit committee to ask the auditor

At the audit planning meeting(s)

- Can you explain the rationale for the audit plan and timetable?
- What is your view of the finance process and function?
- What are the key audit risks this year and how do these impact on financial reporting?
- What financial disclosures are critical in connection with the key audit risks and why?

During the audit

- What is the attitude and level of commitment of management to financial reporting?
- Are there any unidentified risks we should be articulating in the annual report?

At the audit completion meeting(s)

- Have you noticed any changes in the quality of the company's financial reporting?
- What can be done to make the financial reporting process more effective?
- What three things should the company do differently?

For a private meeting with the auditor at the end of the audit

- Does management generally address issues raised during the audit?
- What aspects of the financial statements and associated notes need improving?
- Have these issues been identified previously?
- Have you discussed your views with the CFO and other executive directors?
- How do we compare in this area to other companies of a similar size?

Conclusions

With independent oversight of the annual reporting process, audit committees are integral to improving financial reporting quality.

Acknowledging that smaller quoted companies face specific challenges, such as constraints on time and resources within finance departments, the audit committee can play a useful role in helping to effect change. By asking the right questions at the right time and suggesting practical changes, such as those set out in this guide, audit committees can nurture a general culture of continuous improvement in financial reporting.



Useful resources

Quoted Company Alliance (QCA) corporate governance code

<https://www.theqca.com/shop/guides/>

QCA 'Inspiring Trust' audit committee guide for small and mid-size quoted companies

<https://bit.ly/2XMZYhd>

FRC's Annual Review of Corporate Governance and Reporting 2017/18

<https://bit.ly/2SfRcGt>

FRC's thematic review findings

<https://bit.ly/2AT1Lsn>

UK Corporate Governance Code

<https://bit.ly/2K5mvig>

Guidance on Audit Committees

<https://bit.ly/2PVJCT8>

FRC Guidance on Risk Management, Internal Control and Related Financial and Business Reporting

<https://bit.ly/2A0XPq2>

FRC Audit Quality - Practice Aid for Audit Committees

<https://bit.ly/2UZRBC4>

FRC year-end letter to finance directors and audit committee chairs

<https://bit.ly/2RNxCox>

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ICAEW's Financial Reporting Resources

<https://www.icaew.com/technical/financial-reporting>



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