Reforming regulation initiative

Achieving effective and transparent corporate reporting

More effective and transparent corporate reporting in the UK will result in:

- A growth in capital markets, as the market will have increased confidence in the UK reporting regime. This in turn will attract more investors and businesses to the UK;
- Shareholders and stakeholders having a better understanding of the companies they invest in and conduct business with, as companies will provide them with clear and appropriate information to help them make investment and commercial decisions; and
- Making corporate reporting fit for the future.

Advantages of a vibrant public market

Vibrant and well-functioning capital markets support economic growth and development. Capital markets mobilise commercial finance thereby supporting all parts of the economy from financing large infrastructure developments, such as the development of housing and telecommunications, to investing in growing entrepreneurial businesses at the grass roots of the UK economy.

It is not only the users of capital that benefit, investors do too. Pension funds, institutional and retail investors all profit from having strong capital markets. They invest in the expectation of receiving income and/or capital growth in the future.

Strong public markets also attract international capital to the UK, providing jobs and supporting our economy.

Current position of public markets in the UK

There are many benefits of being on a public market. Listing provides a company with the ability to access capital, it increases its profile, which can increase demand for the company's shares, and improves its liquidity. It also helps broaden the company's shareholder base.

The number of listed companies has declined in recent years. A recent report by the British Business Bank, The Future of Defined Contribution Pensions, (September 2019) stated:

> "*In the UK and the US, the number of listed companies has declined by 25% since 2005 and by 50% since 1996. This trend continues unabated. In the UK, 500 firms have delisted in the ten years to 2015. The impact on UK stock market capitalisation has been significant: since 1999, it has declined from 190% of GDP to 110%.*"

In contrast to the listed market, private markets have grown rapidly. This trend is expected to continue. Additionally, as noted by the British Business Bank report, there is "*a notable trend across high-growth sectors for companies to remain private for longer, prior to listing*".

One of the reasons that public markets are becoming less attractive is because of the regulatory and compliance costs companies incur. For example, when a listed company wishes to raise additional capital it may need to publish a supplementary prospectus. Listed companies also have other legal, regulatory and compliance considerations. For example, additional disclosures are required in their annual reports and accounts.

Changes to regulation and corporate reporting need to be made to support the UK listed sector. That is not to say standards need to be lowered, but changes can be made that would result in better reporting delivered in a less onerous and more accessible way. These changes would support the UK economy and ensure the UK retains its position as a leading financial centre, offering a well-regulated market that meets the needs of both companies and investors.

The Conservative Party's general election manifesto in 2019 committed to fostering and encouraging British businesses, large and small. It states that:

> "*Good regulation is essential to successful businesses: we will strive to achieve the right regulatory balance… Through our Red Tape Challenge, we will ensure that regulation is sensible and proportionate… when devising new rules, using our new freedom after Brexit to ensure that British rules work for British companies.*"

Removing unnecessary administrative and regulatory burdens will achieve the right regulatory balance. Potential areas for reform are discussed below.

Raising new capital

There is significant scope for a review of the prospectus regime to secure benefits for existing, and potential future, users of capital markets without compromising investor protection. The AIC **recommends** this is achieved by removing the obligation for issuers to prepare a prospectus for secondary issues of shares in the same class as others already admitted to trading on a regulated market.

It is not necessary for issuers to prepare a prospectus for further issues in these circumstances. Investors already have access to a high level of publicly available information, including the annual report and accounts and other regulatory announcements required under transparency rules. These disclosures deliver high levels of transparency and allow informed investment decisions to be made. There is no reason to require the publication of a prospectus simply because new shares are being issued.

Removing the prospectus requirement in this situation does not reduce shareholder control over new issues. Shareholder approval would still be required to allow the company to issue additional shares. Also, the proposal does not reduce the need for clear shareholder communication and engagement to persuade investors of the merits of a proposed issue. The proposed deregulation would end the need for an expensive, duplicative disclosure where the content is driven by compliance considerations. Instead, it would focus the attention of issuers on providing clear, accessible investor communication. These would reflect the specific considerations relevant to whether there are good commercial grounds for a further issue of shares to be approved.

Corporate reporting to meet the needs of users

Annual reports currently provide shareholders with historic financial information about the company. They also seek to provide investors with an understanding of how a company is governed, its strategy and how it operates in the best interests of its shareholders.

Investors are increasingly demanding more information about companies. Not only about their financial position, but also about every aspect of their operations. Companies should seek to provide their shareholders with the information they want. However, continuing to increase the scope of the annual report to address other aspects of a company's operations is not sustainable or appropriate. There needs to be a balance between meeting the needs of shareholders, meeting the needs of stakeholders, and making annual reports fit for purpose.

Annual reporting requirements should not become overly prescriptive or burdensome to companies. Companies should not be required to report on a uniform basis about matters that may not be material to their operations, or of value to their shareholders.

The AIC has long been concerned about the length and complexity of annual reports. The AIC **recommends** that a wider review of corporate reporting is undertaken. The AIC also **recommends** that this review includes considering splitting corporate reporting into separate components to make it more effective tool for shareholders and stakeholders (see below).

All of these reports could be required to be on the company's website so they can be easily located by users.

Components of corporate reporting

- **'Strategic Report'** – This would be the principal disclosure for most shareholders. It would include the current Strategic Report or Management Report. It would provide a high-level overview of what the company does and how it has performed in the period. It could also include more forward-looking information. The Strategic Report should include a clear signpost for shareholders detailing where additional information, such as the Historic Report (see below), can be found online.

- **'Historic Report'** – This would be a backward-looking document. It would contain information that is required by company law and accounting standards. It would include, for example, the directors' report, corporate governance statement, directors' remuneration report, statement of directors' responsibilities, and the full financial statements.

- '**Bespoke Report'** – This report would be optional. If companies chose to publish a bespoke report, it would include information that is not required but gives shareholders a better insight into certain aspects of a company's operations. It would be for each company to assess whether such a report would be useful to its shareholders and what it should contain. This could include other information that shareholders of the company have indicated they particularly value. For example, it could include a specific report on cyber security, ESG matters, or internal controls. Where information on these areas is required by legislation that would be included in the strategic or Historic Report, but further information could be given in the bespoke report.

  This report would not necessarily need to be published at the same time as the company's Strategic and Historic Reports, reducing the burden on companies. It would also not necessarily be required to be produced each year. The content could be different from one report to another to meet the specific demands of shareholders allowing companies to tailor the information to the company itself, its size or its sector.

- '**Legal and Regulatory Disclosures Document**' – This document would be mandatory. It would include information that is required by law and/or regulation but is not material to the understanding of the nature and performance of the company.

For example, investment companies may include a statement on greenhouse gas emissions in this document. Investment companies do not have employees or premises. Accordingly, many investment companies currently state in their annual reports that the company has no greenhouse gas emissions.

Other benefits of the AIC's proposals

Adopting these proposals will significantly enhance the quality of reporting not only for shareholders but also for other users of annual reports. Investors will receive the information they need in a digestible and accessible format. They will be able to access further, more detailed information about a company if they choose to do so.

Each report or disclosure will be focused. Currently, annual reports and accounts contain an extensive amount of information. This does not help users see "the wood from the trees". Adopting these proposals will remove superfluous information from both the Strategic report and the Historic Report.

Investor protection and access to information will not be compromised. Although there may be resistance to change, investors will have access to the same information that they do now, but this will be organised and presented in a better way. These proposals recognise that users of corporate information use information in different ways. For example, a retail shareholder will not look at information in the same way as an analyst or a professional investor.

Future proofing corporate reporting

The AIC **recommends** that a policy decision is taken to establish the principle that future legal or regulatory information that companies will be required to report should not be included in the Strategic Report or Historic Report unless it is material to the company's operations and/or pertain to accounting standards. Instead it would be included in the Legal and Regulatory Disclosure Document.

The AIC also **recommends** that a review is undertaken to remove some of the current legal and regulatory requirements from annual reports, particularly where this is not material to understand the nature and performance of the company. These types of disclosures do not add value. They detract from the key issues that annual reports should seek to address and communicate to their shareholders. If the AIC's proposals are adopted, these disclosures should be provided in the company's Legal and Regulatory Disclosures Document.

Providing clarity over the role of audit

Financial statements are audited. Audit is a backward-looking check on the company's financial transactions. The audit report is signed by a qualified auditing and accounting professional. While the audit function is well understood and valued by shareholders, confusion often arises over which parts of the annual report are audited, and the role the auditor has in reviewing other parts of the annual report, the so-called 'expectations gap'.

Splitting corporate reporting into different components, as set out above, will provide clarity over the role of the auditor.

It will also ensure shareholders are provided with appropriate assurance over each component of corporate reporting. The AIC **recommends** that:

- The Historic Report is audited. This report contains information that is required by company law, regulations or accounting standards. This report would also contain the auditor's report which explains the scope of the audit, the responsibilities of the auditor, and the audit opinion.

- The Strategic Report would not be audited. To ensure its credibility, it would include a short statement from the auditor confirming that the information is consistent with the Historic Report (see above). This will not create a significant increase in time or cost as auditors currently perform this as part of their audit work.

  Where companies, shareholders or wider stakeholders demand more assurance, for example on more forward-looking statements, this can be provided by a reporting accountant, or other appropriate consultant, based on a defined and agreed scope.

- The Bespoke Report, or sections from it, could be reviewed by independent specialists with knowledge and experience in specific fields. Their report/(s) would be based on a defined and agreed scope. Different levels of liability could also be agreed depending on the work undertaken and the contractual agreement between the supplier and the company.

- The Legal and Regulatory Disclosures Document would not be audited. Companies may decide that they would like elements of these disclosures to be reviewed by independent specialists with knowledge and experience in specific fields. Their report/(s) would be based on a defined and agreed scope. Different levels of liability could also be agreed depending on the work undertaken and the contractual agreement between the supplier and the company.

This approach clarifies that the auditor's focus is on the Historic Report. It also allows companies and shareholders to decide whether they would like assurance over other areas of corporate reporting and, if so, what areas they would like to be reviewed.

Dangers of a flawed reporting environment

If the UK does not act to reform its corporate reporting environment and increases the regulatory and compliance time costs and burdens on companies, whilst not providing shareholders and stakeholders with the information they need, there is a risk that companies and investors will seek to go elsewhere. This will damage the UK's economy and its capital markets.

Corporate reporting should help shareholders make informed investment decisions, but the wealth of information included in annual reports masks key issues that companies are trying to convey. More worryingly, it potentially also masks fundamental problems that could lead to the demise of companies.

Many of the recent reviews concerning corporate reporting and audit reform have recommended increased disclosures to try and meet the needs of shareholders and stakeholders. More is not always the right approach. Transparency is a good thing, but simply increasing the amount of information provided to shareholders will not equip them with the information they need to make informed decisions.

There is scope to improve the quality of reporting, reduce the volume of unnecessary disclosures, increase transparency for users and reduce the administrative and cost burdens placed on companies. This is vital as it is increasingly difficult for shareholders to extract key information and identify matters of interest from the disclosures in the annual report and accounts. Much of the relevant and current information is lost amongst 'boilerplate', mandatory disclosures.

If the approach to annual reports is not reformed, they will continue to increase in length and complexity. This will result in:

- The increased involvement of lawyers in drafting the annual report. If further information is continually required to be included in the annual report, particularly in relation to more forward-looking statements, directors will seek the advice of lawyers or other specialist advisers and ask them to review the annual report. This will result in annual reports becoming more complex and written in a more legalistic way. It will increase the costs of preparing annual reports which will ultimately be borne by shareholders;
- More complex annual reports which would not be tailored towards providing shareholders with the information they need. This is particularly the case where regulators adopt a one-size-fits-all approach leading to lengthy 'boilerplate' disclosures being provided;
- Auditors being required to audit or review an increasing wealth of information included within the annual report, some of which may not be within their area of expertise to comment on. This will increase the costs to the company which will ultimately be borne by shareholders without them receiving any significant benefits; and
- Further confusion about what auditors do and what information they provide an opinion on.

Legislators and regulators need to balance the increasing demand for companies to provide more information with having a proportionate, fit for purpose, reporting regime that supports a transparent capital market and gives shareholders and stakeholders the information they need in a clear, succinct and understandable format.

Delivering the benefits of Brexit

Developing and supporting a strong regulatory environment for the listed market should be central to the government's approach after the Transition Period ends on 31 December 2020. This can be achieved by removing the barriers for listed companies to raise capital, thereby supporting and strengthening our economy.

Brexit also provides policy makers with the opportunity to design a corporate reporting framework which strengthens the attractiveness of the UK market, whilst meeting the needs of the listed market, shareholders and other users of accounts.

These proposals will continue to protect investors whilst providing them with clear, relevant, and transparent information that meets their needs. They will help address the audit expectations gap and reduce financial costs and unnecessary regulatory burdens for companies.

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