GREEN PAPER ON THE LONG-TERM FINANCING OF THE EUROPEAN ECONOMY

RESPONSE FROM ICAS TO THE EC

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Introduction

The Institute of Chartered Accountants of Scotland (ICAS) welcomes the opportunity to comment on this EC consultation paper. We are a professional body for over 19,000 members who work in the UK and in more than 100 countries around the world. Our members represent different sizes of accountancy practice, financial services, industry, the investment community and the public sector. Almost two thirds of our working membership work in business, many leading some of the UK's and the world's great companies.

ICAS's Charter requires it to act primarily in the public interest, and our responses to consultations are therefore intended to place the public interest first. Our Charter also requires us to represent our members' views and to protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

Key messages

Accounting principles

We do not believe there is any association with the use of fair value measurement in certain areas of financial reporting and short-termism in investor behaviour. Financial statements are published after the event and do not appear to be a driver in investment decisions. The research cited is inconclusive. We would point you to our submission to the House of Lords inquiry[1] and oral transcript[2] which explains how the principle of fair value is balanced by the need for financial statements to show a true and fair view. Fair value is enshrined in IFRS. IAS 1 paragraph 19 requires a preparer to depart from an IFRS if it does not represent faithfully the transactions, other events and conditions it purports to, or could reasonably be expected to represent. What are the alternatives to fair value? Historic cost is likely over time to diverge significantly from market value so arguably the accounts would be more distorted. We believe that the question is less how to value but more about attitudes and behaviours. This links to strong business ethics and corporate governance.

In terms of on-going improvement and development, the IASB conceptual framework is currently being updated. Clarification of measurement principles would be helpful to ascertain when fair value is appropriate and when other bases should apply. The IASB is also seeking to amend and simplify in IFRS 9 the classification and measurement of financial instruments held at fair value and address hedge accounting requirements.

Technical accounting information needs to be balanced be meaningful narrative information in the front end of the annual report. See further comments in the section on "information and reporting" below.

Corporate governance arrangements

Our preference is that corporate governance arrangements are improved through non regulatory mechanisms. The "comply or explain" approach used by the UK Financial Reporting Council (FRC) for their Corporate Governance Code and the new Stewardship Code for institutional shareholders have been found to assist companies to engage with the compliance aspects of the Code whilst allowing them freedom to explain any instances where they feel this is not appropriate in their particular situation.

[1] http://www.publications.parliament.uk/pa/jt201213/jtselect/jtpcbs/writev/panelontax/m01.htm
[2] HoL Oral Evidence by Sir David Tweedie_recording

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The Financial Reporting Council (FRC) report a high level of compliance with the 'comply or explain' regime contained in the Corporate Governance Code. We are firm supporters of this approach although we do recognise that on occasion, explanations offered by companies could be improved. This was highlighted by Grant Thornton in its recent research publication[3]. We are therefore supportive of the recent announcement by the FRC of its proposal to provide greater guidance as to what constitutes an acceptable explanation when a company decides not to follow the requirements of a specific principle of the Code.

We are supportive of the findings of the Kay Review of UK Equity Markets and Long-Term Decision Making (July 2012) and would refer the EC to this paper. We would highlight the following messages and recommendations to encourage longer term behaviour:

- A good practice statement for company directors which underlines their role as stewards of the business and duties to the company not its share price; and the emphasis on creating/ maintaining competitive advantage in operating business as the only long-term source of shareholder value (chapter 8)
- Chapter 9 on fiduciary duty. This is defined as including loyalty and prudence; stewardship implies the management of funds to fiduciary standards and this should extend to both asset managers and any intermediaries used to undertake investment on behalf of savers. Current regulatory obligations and principles set by the Financial Services Agency (FSA) differ from the standards implied by fiduciary duty. The detailed requirements are substantially influenced by EU legislation. We support recommendation 7 arising in chapter 9 that:
  “Regulatory authorities at EU and domestic level should apply fiduciary standards to all relationships in the investment chain which involve discretion over the investments of others, or advice on investment decisions. These obligations should be independent of the classification of the client, and should not be capable of being contractually overridden”.
- Anomalies in disclosure of charges which make investment strategies appear more costly relative to trading strategies are misleading. Recommendation 8 states:
  Asset managers should make full disclosure of all costs, including actual or estimated transactions costs, and performance fees charged to the fund.
  It would also be helpful for those authorised to manage client funds to disclose their policy for remunerating fund managers to better demonstrate that remuneration policies and fund manager’s interests are aligned with the asset owner. We recognise that some fund managers already follow this approach but are not convinced that this good practice is widespread across the sector.
- Chapter 10 including recommendations to remove quarterly reporting obligations and encourage high quality, succinct narrative reporting based on informed judgement, not prescriptively regulated.
- Chapter 11 on market incentives; and
- Chapter 12 on regulating equity markets including a proposal that regulatory philosophy should shift to focus on business models, strategies, risks and outcomes than primarily on systems and processes” and for these to be taken on board by the EC in the design of European financial services regulation (paragraph 12.2)

Information and reporting

We suggest that there is an issue of corporate reports being too long and unnecessarily complex. ICAS has been actively engaged to improve the quality of corporate reporting for example Making Corporate Reports Relevant. We believe that corporate reporting needs to evolve to better explain the entity’s strategy and business model – how it makes money and how it seeks to sustain that money-making over time – and the main risks it is assuming in pursuing that business model. This is the key information which investors need to know as a basis for investing or retaining their investment for the longer term.

[3] http://www.grant-thornton.co.uk/pdf/corporate_governance.pdf (page 7)

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Currently the UK Government has drafted regulations on improving company non-financial reporting. It is expected that these changes will become law by October 2013. The changes are focused on quoted companies and include replacing the existing business review with a strategic report which comments on an entity's business model.

ICAS will be providing a consultation response to the International Integrated Reporting Council on their draft framework for an integrated report. This will be published on our web-site[4]. We suggest that the focus should be on improving the "front ends" of annual reports, with a view to embedding integrated reporting principles and concepts into an entity's current reporting process, the result being that annual reports will ultimately become "integrated" reports.

The ease of SMEs to access bank and non-bank financing

Role of regulation
We have some concerns that further EU regulation would hinder developments already on going in different jurisdictions; the markets in individual countries differ so widely and the UK has a strong tradition of investor protection. New sources of funding and funding initiatives need to be supported and nurtured without being choked by regulation.

Prioritisation of growth and State Aid Rules
Both the UK Government and European Commission have prioritised growth. The purpose and intentions of EC State Aid Rules, to ensure that government interventions do not distort competition and trade inside the EU, is important. However, we wish to point out that we have seen examples of some national growth initiatives and tax incentives for investment in SMEs blocked by state aid restrictions. In practice these Rules have inadvertently served to dilute or limit a number of national growth initiatives

Economic priorities in the world today are different from the days when this law was conceived. In these exceptional times, we believe that State Aid Rules need an urgent reassessment to allow growth to be reprioritised over competition and to modify or remove those rules which stifle that overarching priority. The existing measures have moved beyond the scope of large scale government intervention. We do not believe it is sensible for the same restrictions to apply to SMEs whose impact on competition within the EU is negligible or nil. Tax reliefs are vital to secure equity investment in SMEs. A massive boost to such investment (quite independently of bank finance) is required to effectively drive forward start-ups and develop small businesses, which in turn provide the most dynamic increases to employment.

We would welcome greater proportionality of State Aid rules and targeting on those organisations which are likely to have the largest and most significant market impact. Small and medium-sized enterprises (SME) account for 99.9% of all enterprises and 58.8% of private sector employment[5] in the UK. The role of SMEs is crucial in a successful growth strategy. We believe that SMEs should be exempted from EC State Aid Rules to give governments the freedom to apply growth initiatives designed to match the needs in each country.

Fund management
Open-ended funds (including an Open Ended Investment Company (OEIC) and life funds, as well as segregated mandates from pension schemes and other investors) are managed under mandates which allow the investor to change manager or restructure their investment portfolio when they wish. OEICs are normally run as an Undertaking for Collective Investment in Transferable Securities UCITS under the EU Directive which requires investment only in liquid stocks. Most such mandates managed in Scotland are therefore subject to restrictions which require the manager only to invest in liquid investments i.e. those that can in principle be bought and sold on a daily (or sometimes monthly) basis through recognised stock exchanges or by selling back to the UCITS/life fund itself.

[4] http://icas.org.uk/technical-research/financial-reporting/submissions/
[5] BIS population estimates for UK and regions 2011

In order to change fund manager behaviour, trustees must change these mandates to permit less liquid investments to be made. Higher returns may be made where liquidity is lower, hence the fact that certain pension funds invest in unquoted equities, normally through special purpose limited life partnerships (typically 7 - 10 years) where a lack of liquidity is accepted for that period for a portion of the fund. Trustees normally choose specialist managers to make such investments.

Over the last 3 decades or so, such specialist managers have tended to invest more in larger scale 'private equity' deals which offer significant returns quite quickly, in preference to smaller and earlier stage deals in start-ups, which suffer much greater risks and on average have resulted in lower (even negative) returns. The main way in which start up and early stage/lower value investments have been encouraged is through tax reliefs – enterprise investment scheme[6] and Venture Capital Trusts for example. What is now required (given the low returns offered in conventional investments such as cash and bonds) is encouragement for trustees to reconsider investing more patiently in higher risk investments again through specialist investors and to relax the habit of insisting on high liquidity in investments that are made.

We would encourage using portfolios to share risk and recognise this as a better risk mitigation model in the design of regulation e.g. investor protection rules should not necessarily apply to small scale corporate deals if the investors understand the risks. We suggest replacing investor protection rules which apply to investment adverts with better education to apply portfolio theory to relevant investors. As an example, a Venture Capitalist Trust (VCT) may be considered a stable investment as part of a portfolio as it may include 40/50 companies of which some may go bust but leaving the overall investment in profit.

There also needs to be scope to trust the investor more. As an example, investment rules (such as for prospectuses) are so tight that those who advise (e.g. stockbrokers) are assumed to be operating to these standards in everything they advise on. There should be the opportunity for advisers to make clients aware of opportunities to invest in smaller companies which do not have 'prospectus' standards in their investment adverts. This requires a change in Financial Conduct Authority rules, and in the ingrained habits of advisers who are (because of negligence risks) very wary of making clients aware of such opportunities.

Finally, we are not convinced that SME lending should have different characteristics from any other lending and so need a separate market.

[6] http://www.hmrc.gov.uk/eis/

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