FOREWORD TO ACCOUNTING STANDARDS

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FOREWORD TO ACCOUNTING STANDARDS

Introduction

1 This foreword explains the authority, scope and application of accounting standards issued or adopted by the Accounting Standards Board (the Board)[1]. The foreword also considers the procedure by which the Board issues accounting standards and their relationship to International Accounting Standards, issued by the International Accounting Standards Committee.

2 The Board at its meeting on 24 August 1990 agreed to adopt the 22 extant Statements of Standard Accounting Practice (SSAPS) issued by the Councils of the six major accountancy bodies following proposals developed by the Accounting Standards Committee (ASC)[2]. Adoption by the Board gave these SSAPs the status of accounting standards within Part VII of the Companies Act 1985,[3] (the Act) and within Part VIII of the Companies (Northern Ireland) Order 1986[4] (the Order). This status will apply until each SSAP is amended, rescinded or replaced by new accounting standards.

3 Accounting standards developed by the Board are designated Financial Reporting Standards (FRSs). Accounting standards developed by the ASC and adopted by the Board continue to be known as SSAPs.

4 FRSs are based on the Statement of Principles for Financial Reporting, currently in issue, which addresses the concepts underlying the information presented in financial statements. The objective of this Statement of Principles is to provide a framework for the consistent and logical formulation of individual accounting standards. The framework also provides a basis on which others can exercise judgement in resolving accounting issues.

5 The Board may issue pronouncements other than FRSs, including the Urgent Issues Task Force 'Abstracts'. The Board will indicate the authority, scope and application of pronouncements other than FRSs as they are issued. UITF Abstracts are the subject of a separate foreword.

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[1] *The Accounting Standards Board is a committee of The Accounting Standards Board Limited. The Accounting Standards Board Limited is prescribed as a standard setting body for the purposes of Section 256(1) of the Companies Act 1985 with effect from 20 August 1990 by The Accounting Standards (Prescribed Body) Regulations 1990 (S.I. 1990 No. 1667). The Accounting Standards Board Limited is prescribed as a standard setting body for Northern Ireland for the purposes of Article 264(1) of the Companies (Northern Ireland) Order 1986 with effect from 15 October 1990, by the Accounting Standards (Prescribed Body) Regulations (Northern Ireland) 1990 (S.R. 1990 No. 338).*

[2] *Prior to 1 August 1990 accounting standards in the United Kingdom and Republic of Ireland were issued by the Councils of the six major accountancy bodies following proposals developed by the* ASC. *Since 1 August 1990 the Board has taken over the role of issuing accounting standards applicable in the United Kingdom. The Institute of Chartered Accountants in Ireland issues accounting, standards applicable in the Republic of Ireland.*

[3] *References to the Companies Act 1985 are to that Act as amended by, inter alia, the Companies Act 1989 and the Companies Act 1985 (Bank Accounts) Regulations 1991 (S.I. 1991 No. 2705).*

[4] *References to the Companies (Northern Ireland) Order 1986 (S.I. 1986 No. 1032 (NI. 6)) are to that Order as amended by, inter alia, the Companies (Northern Ireland) Order 1990 (S.I. 1990 No. 593 (N.I. 5)), the Companies (No. 2) (Northern Ireland) Order 1990 (S.I. 1990 No. 1504 (N.I. 10)) and the Companies (1986 Order) (Bank Accounts) Regulations (Northern Ireland) Order (S.R. 1992 No. 258).*

Aims of the Accounting, Standards Board

6 The aims of the Board are set out in the document 'The Accounting Standards Board - Statement of Aims'.

Authority of accounting standards

7 FRSs issued and SSAPs adopted by the Board are ‘accounting standards’ for the purposes of the Act, which requires accounts, other than those prepared by small or medium-sized companies (as defined by the Act), to state whether they have been prepared in accordance with applicable accounting standards and to give particulars of any material departure from those standards and the reasons for it. References to accounting standards in the Act are contained in paragraph 36A of Schedule 4, paragraph 49 of Part 1 of Schedule 9 and paragraph 18B of Part 1 of Schedule 9A. The equivalent references in the Order are in paragraph 36A of Schedule 4, paragraph 49 of Part 1 of Schedule 9 and paragraph 18B of Part 1 of Schedule 9A.

8 Directors of companies incorporated under the Companies Acts are required by the Act to prepare accounts that give a true and fair view of the state of affairs of the company, and where applicable the group, at the end of the financial year and of the profit or loss of the company or the group for the financial year.

9 The Consultative Committee of Accountancy Bodies (CCAB) is committed to promoting and supporting compliance with accounting standards by its member bodies and by their members, whether as preparers or auditors of financial information.

10 The Councils of the CCAB bodies therefore expect their members who assume responsibilities in respect of financial statements to observe accounting standards. The Councils have agreed that:

a where this responsibility is evidenced by the association of members' names with such financial statements in the capacity of directors or other officers, other than auditors, the onus will be on them to ensure that the existence and purpose of accounting standards are fully understood by fellow directors and other officers. Members should also use their best endeavours to ensure that accounting standards are observed and that significant departures found to be necessary are adequately disclosed and explained in the financial statements.

b where members act as auditors or reporting accountants, they should be in a position to justify significant departures to the extent that their concurrence with the departures is stated or implied. They are not, however, required to refer in their report to departures with which they concur, provided that adequate disclosure has been made in the notes to the financial statements.

11 The CCAB bodies, through appropriate committees, may enquire into apparent failures by their members to observe accounting standards or to ensure adequate disclosure of significant departures.

12 The Board notes the continuing application of previously adopted SSAPs in the Republic of Ireland through their on-going promulgation by the Institute of Chartered Accountants in Ireland (ICAI). It further notes ICAI's intention of maintaining close liaison with the Board on promulgating, with appropriate modifications for legal differences, FRSs for application in the Republic of Ireland. The objective of the Board and ICAI is a regime of accounting standards common to both the United Kingdom and the Republic of Ireland.

Scope and application of accounting standards

13 Accounting standards are applicable to financial statements of a reporting entity that are intended to give a true and fair view of its state of affairs at the balance sheet date and of its profit or loss (or income and expenditure) for the financial period ending on that date. Accounting standards need not be applied to immaterial items.

14 Accounting standards should be applied to United Kingdom and Republic of Ireland group financial statements (including any amounts relating to overseas entitles that are included in those financial statements). Accounting standards are not intended to apply to financial statements of overseas entitles prepared for local purposes.

15 Where accounting standards prescribe information to be contained in financial statements, such requirements do not override exemptions from disclosure given by law to, and utilised by, certain types of entity.

Compliance with accounting standards

16 Accounting standards are authoritative statements of how particular types of transaction and other events should be reflected in financial statements and accordingly compliance with accounting standards will normally be necessary for financial statements to give a true and fair view.

17 In applying accounting standards it is important to be guided by the spirit and reasoning behind them. The spirit and reasoning are set out in the individual FRSs and are based on the Board's Statement of Principles for Financial Reporting.

18 The requirement to give a true and fair view may in special circumstances require a departure from accounting standards. However, because accounting standards are formulated with the objective of ensuring that the information resulting from their application faithfully represents the underlying commercial activity, the Board envisages that only in exceptional circumstances will departure from the requirements of an accounting standard be necessary in order for financial statements to give a true and fair view.

19 If in exceptional circumstances compliance with the requirements of an accounting standard is inconsistent with the requirement to give a true and fair view, the requirements of the accounting standard should be departed

from to the extent necessary to give a true and fair view. In such cases informed and unbiased judgement should be used to devise an appropriate alternative treatment, which should be consistent with the economic and commercial characteristics of the circumstances concerned. Particulars of any material departure from an accounting standard, the reasons for it and its financial effects should be disclosed in the financial statements. The disclosure made should be equivalent to that given in respect of departures from specific accounting provisions of companies legislation.

20 The Financial Reporting Review Panel (the Review Panel) and the Department of Trade and Industry have procedures for receiving and investigating complaints regarding the annual accounts of companies in respect of apparent departures from the accounting requirements of the Act, including the requirement to give a true and fair view.[5] The Review Panel will be concerned with material departures from accounting standards, where as a result the accounts in question do not give a true and fair view, but it will also cover other departures from the accounting provisions of the Act. The Review Panel is empowered by regulations made under the Act to apply to the court for a declaration or declarator that the annual accounts of a company do not comply with the requirements of the Act and an order requiring the directors of the company to prepare revised accounts.[6] The Department of Trade and Industry has similar powers.

The public sector

21 The prescription of accounting requirements for the public sector in the United Kingdom is a matter for the Government. Where public sector bodies prepare annual reports and accounts on commercial lines, the Government's requirements may or may not refer specifically either to accounting standards or to the need for the financial statements concerned to give a true and fair view. However, it can be expected that the Government's requirements in such cases will normally accord with the principles underlying the Board's pronouncements, except where in the particular circumstances of the public sector bodies concerned the Government considers these principles to be inappropriate or considers others to be more appropriate.

22 In the Republic of Ireland accounting standards will normally be applicable to reporting entities in the public sector as such entities are either established under companies legislation or are established under special legislation which requires them to produce financial statements which give a true and fair view.

The issue of a Financial Reporting Standard

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[5] *Similar provisions exist for receiving and investigating complaints regarding the annual accounts of companies in respect of apparent departure from the accounting requirements of the Order.*

[6] *The Review Panel does not operate in the Republic of Ireland.*

23 Topics that become the subject of FRSs are identified by the Board either from its own research or from external sources, including submissions from interested parties.

24 When a topic is identified by the Board as requiring the issue of an FRS the Board commissions its staff to undertake a programme of research and consultation. This programme involves consideration of and consultation on the relevant conceptual issues, existing pronouncements and practice in the United Kingdom, the Republic of Ireland and overseas and the economic, legal and practical implications of the introduction of particular accounting requirements.

25 When the issues have been identified and debated by the Board a discussion draft is normally produced and circulated to parties who have registered their interest with the Board. When the issues require a more discursive treatment a discussion paper may be published instead. The purpose of either of these documents is to form a basis for discussion with parties particularly affected by, or having knowledge of, the issues raised in the proposals. An exposure draft of an accounting standard (a Financial Reporting Exposure Draft or FRED) is then published to allow an opportunity for all interested parties to comment on the proposals and for the Board to gauge the appropriateness and level of acceptance of those proposals.

26 The exposure draft is refined in the light of feedback resulting from the period of public exposure. There may follow another period of public or selective exposure prior to the issue of an FRS. Although the Board weighs carefully the views of interested parties, the ultimate content of an FRS must be determined by the Board's own judgement based on research, public consultation and careful deliberation about the benefits and costs of providing the resulting information.

Applicability of an accounting standard to transactions entered into before the standard was issued

27 When a new accounting standard is issued the question arises whether its provisions should be applied to transactions which took place prior to the promulgation of the standard. The general policy of the Board is that the provisions of accounting standards should be applied to all material transactions irrespective of the date at which they are entered into. This is because exemption of certain transactions leads to similar transactions being accounted for differently in the same set of accounts, and can also hinder the comparison of the accounts of one entity with another.

28 In a few instances, application of the provisions of accounting standards to past transactions will entail a considerable amount of work and may result in information which is difficult for the user of accounts to interpret. In such a case, in drafting the standard the Board will consider incorporating an exclusion for transactions which took place prior to the promulgation of the standard.

29 In some instances, a new standard may have unforeseen consequences where financial statements are used to monitor compliance with contracts and agreements. The most widespread example is the covenants contained in banking and loan agreements, which may impose limits on measures such as net worth or gearing as shown in the borrower's financial statements.

30 The Board considers that the developing nature of accounting requirements is a long-established fact that would be known to the parties when they entered into the agreement. It is up to the parties to determine whether the agreement should be insulated from the effects of a future accounting standard or, if not, the manner in which it might be renegotiated to reflect changes in reporting rather than changes in the underlying financial position.[7] The Board, therefore, has no general policy of exempting transactions occurring before a specific date from the requirements of new accounting standards.

Early adoption of Financial Reporting Exposure Drafts.[8]

31 An exposure draft is issued for comment and is subject to revision. Until it is converted into an accounting standard the requirements of any existing accounting standards that would be affected by proposals in the exposure draft remain in force.

32 Some companies or other reporting entitles may wish to provide additional information reflecting proposals in an exposure draft. In the Board's view there are two ways that this can be achieved:

a insofar as the information does not conflict with existing accounting standards , it could be incorporated in the financial statements. It should be remembered, however, that the proposals may change before forming part of an accounting standard and the consequences of a change to the proposals should be considered.

b the information could be provided in supplementary form.

Reviews of accounting standards

33 Accounting standards are issued against the background of a business environment that evolves over time. The Board is, therefore, receptive to comments on accounting standards, recognising that, for some, a substantial period may be needed before their effectiveness can be judged, while in other cases there may be special reasons why an earlier review is necessary. However, the Board believes that it will normally be appropriate to allow new accounting standards a period in which to become established before commencing a process of formal post-issue review.

Accounting standards and the legal framework

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[7] *The British Bankers' Association has indicated that it does not believe that problems arising from breaches in covenants consequent upon changes in accounting policies will occur frequently in practice.*

[8] *Similar considerations apply to discussion documents issued by the Board.*

34 In its debates on any accounting topic the Board initially develops its views by considering how its principles of accounting apply to the possible accounting options available for that topic. However, in deciding what is the most appropriate treatment the Board must also consider the environment in which its standards are to be applied. The legislation with which reporting entities must comply forms an important part of that environment. Accordingly, FRSs are drafted in the context of current United Kingdom and Republic of Ireland legislation and European Community Directives with the aim of ensuring consistency between accounting standards and the law.

35 The status of accounting standards under United Kingdom legislation is addressed in the Opinion by Miss Mary Arden QC[9] 'The true and fair requirement', which is published as an appendix to this Foreword.

International Accounting Standards

36 FRSs are formulated with due regard to international developments. The Board supports the International Accounting Standards Committee in its aim to harmonise international financial reporting. As part of this support an FRS contains a section explaining how it relates to the International Accounting Standard (IAS) dealing with the same topic. In most cases, compliance with an FRS automatically ensures compliance with the relevant IAS. Where the requirements of an accounting standard and an IAS differ, the accounting standard should be followed by entities reporting within the area of application of the Board's accounting standards.

Withdrawal of Explanatory Foreword to Statements of Standard Accounting Practice

37 The 'Explanatory Foreword' to SSAPs, issued by the ASC in May 1975 and revised in May 1986, is superseded by this Foreword and is accordingly withdrawn.

[9] *Now The Honourable Mrs Justice Arden.*

A P P E N D I X

ACCOUNTING STANDARDS BOARD
THE TRUE AND FAIR REQUIREMENT

OPINION

1 This Opinion is concerned with the effect of recent changes in the law on the relationship between accounting standards and the requirement in Sections 226 and 227 of the Companies Act 1985 (as amended) that accounts drawn up in accordance with the Companies Act 1985 give a true and fair view of the state of affairs of the company, and where applicable the group, at the end of the financial year in question and of the profit or loss of the Company or group for that financial year. (I shall call this requirement "the true and fair requirement"). As is well known, the true and fair requirement is overriding. Thus both sections provide that where in special circumstances compliance with the requirements of the Act as to the matters to be included in the accounts would be inconsistent with the true and fair requirement there must be a departure from those requirements to the extent necessary to give a true and fair view (sections 226(5) and 227(6)). The meaning of the true and fair requirement, as it appeared in earlier legislation, was discussed in detail in the Joint Opinions which I wrote in 1983 and 1984 with Leonard Hoffmann Q.C. (now the Right Hon. Lord Justice Hoffmann).

2 As stated in those Opinions, the question whether accounts satisfy the true and fair requirement is a question of law for the Court. However, while the true and fair view which the law requires to be given is not qualified in any way, the task of interpreting the true and fair requirement cannot be performed by the Court without evidence as to the practices and views of accountants. The more authoritative those practices and views, the more ready the Court will be to follow them. Those practices and views do not of course stand still. They respond to such matters as advances in accounting and changes in the economic climate and business practice. The law will not prevent the proper development of the practices and views of accountants but rather, through the process of interpretation, will reflect such development.

3 Up to August 1990 the responsibility for developing accounting standards was discharged by the Accounting Standards Committee ("the ASC"). Since August 1990 that responsibility has been discharged by the

Accounting Standards Board ("the Board"). The Foreword to Accounting Standards approved by the Board describes in particular the circumstances in which accounts are expected to comply with accounting standards. For this purpose the key paragraph is paragraph 16, which provides:

> "Accounting standards are authoritative statements of how particular types of transactions and other events should be reflected in financial statements and accordingly compliance with accounting standards will normally be necessary for financial statements to give a true and fair view."

The Foreword also describes the extensive process of investigation and consultation which precedes the issue of a standard and explains that the major accountancy bodies expect their members to observe accounting standards and may enquire into apparent failures by their members to observe standards or ensure adequate disclosure of departures from them.

4 What is the role of an accounting standard? The initial purpose is to identify proper accounting practice for the benefit of preparers and auditors of accounts. However, because accounts commonly comply with accounting standards, the effect of the issue of standards has also been to create a common understanding between users and preparers of accounts as to how particular items should be treated in accounts and accordingly an expectation that save where good reason exists accounts will comply with applicable accounting standards.

5 The Companies Act 1989 now gives statutory recognition to the existence of accounting standards and by implication to their beneficial role i financial reporting. This recognition is achieved principally through the insertion of a new section (Section 256) into the Companies Act 1985 and of a new disclosure requirement into Schedule 4 to that Act. Section 256 provides:

" 256. (1) In this Part "accounting standards" means statements of standard accounting practice issued by such body or bodies as may be prescribed by regulations.

(2) References in this Part to accounting standards applicable to a company's annual accounts are to such standards as are, in accordance with their terms, relevant to the company's circumstances and to the accounts.

(3) The Secretary of State may make grants to or for the purposes of bodies concerned with -

(a) issuing accounting standards,

(b) overseeing and directing the issuing of such standards, or

(c) investigating departures from such standards or from the accounting requirements of this Act and taking steps to secure compliance with them.

(4) Regulations under this section may contain such transitional and other supplementary and incidental provisions as appear to the Secretary of State to be appropriate."

In addition the notes to financial statements prepared under Schedule 4 must now comply with the following new requirement[10]:-

> "36A. It shall be stated whether the accounts have been prepared in accordance with applicable accounting standards and particulars of any material departure from those standards and the reasons for it shall be given."

6 Another significant change brought about by the 1989 Act is the introduction of a procedure whereby the Secretary of State or a person authorised by him may ask the Court to determine whether annual accounts comply with inter alia the true and fair requirement (Section 245B of the Companies Act 1985). The Financial Reporting Review Panel ("the Review Panel") has been authorised by the Secretary of State for this purpose. By agreement with the Department of Trade and Industry the ambit of the Review Panel is normally public and large private companies, with the Department exercising its powers in other cases.

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[10] This *requirement also applies to group accounts drawn up under Schedule* 4A. *In addition the accounts of banking and insurance companies and groups drawn up under Schedules* 9 *and* 9A *must make the same disclosure. There is an exemption for small and medium-sized companies and for certain small and medium-sized groups.*

7 The changes brought about by the Companies Act 1989 will in my view affect the way in which the Court approaches the question whether compliance with an accounting standard is necessary to satisfy the true and fair view requirement. The Court will infer from Section 256 that statutory policy favours both the issue of accounting standards (by a body prescribed by regulation) and compliance with them: indeed Section 256(3)(c) additionally contemplates the investigation of departures from them and confers power to provide public funding for such purpose. The Court will also in my view infer from paragraph 36A of Schedule 4 that (since the requirement is to disclose particulars of non- compliance rather than of compliance) accounts which meet the true and fair requirement will in general follow rather than depart from standards and that departure is sufficiently abnormal to require to be justified. These factors increase the likelihood, to which the earlier Joint Opinions referred, that the Courts will hold that in general compliance with accounting standards is necessary to meet the true and fair requirement.

8 The status of accounting standards in legal proceedings has also in my view been enhanced by the changes in the standard-setting process since 1989. Prior to the Companies Act 1989 accounting standards were developed by the ASC, which was a committee established by the six professional accountancy bodies who form the Consultative Committee of Accountancy Bodies ("the CCAB") and funded by them. The standard-setting process was reviewed by a committee established by the CCAB under the chairmanship of Sir Ron Dearing CB. The report of that Committee (the Dearing Report), which was published in 1988 and is entitled The Making of Accounting Standards, contained a number of recommendations, including recommendations leading to what are now paragraph 36A and Section 245B and the further recommendation that the standard-setting body should be funded on a wider basis. As a result of the implementation of these recommendations the standard-setting body no longer represents simply the views of the accountancy profession. Its members are appointed by a committee drawn from the Council of the Financial Reporting Council Limited ("the FRC"). The Council includes representatives of the Government, representatives of the business and financial community and members of the accountancy profession. Moreover, the Board is now funded, via the FRC, jointly by the Government, the financial community and the accountancy profession.

9 The statements referred to in Section 256 are of underline accounting practice. Parliament has thus recognised the desirability of standardisation in the accountancy field. The discretion to determine the measure of standardisation is one of the matters left to the Board. By definition, standardisation may restrict the availability of particular accounting treatments. Moreover the Act does not require that the practices required by a standard should necessarily be those prevailing or generally accepted at the time.

10 As explained in the earlier Joint Opinions in relation to statements of standard accounting practice, the immediate effect of the issue of an accounting standard is to create a likelihood that the court will hold that compliance with that standard is necessary to meet the true and fair requirement. That likelihood is strengthened by the degree to which a standard is subsequently accepted in practice. Thus if a particular standard is generally followed, the court is very likely to find that accounts must comply with it in order to show a true and fair view. The converse of that proposition, that non-acceptance of a standard in practice would almost inevitably lead a court to the conclusion that compliance with it was not necessary to meet the true and fair requirement, is not however the case. Whenever a standard is issued by the Board, then, irrespective of the lack in some quarters of support for it, the court would be bound to give special weight to the opinion of the Board in view of its status as the standard-setting body, the process of investigation, discussion and consultation that it will have undertaken before adopting the standard and the evolving nature of accounting standards .

11 The fact that paragraph 36A envisages the possibility of a departure from an "applicable accounting standard" (in essence, any relevant standard: see section 256(2), above) does not mean that the Companies Act permits a departure in any case where the disclosure is given. The departure must have been appropriate in the particular case. If the Court is satisfied that compliance with a standard is necessary to show a true and fair view in that case, a departure will result in a breach of the true and fair requirement even if the paragraph 36A disclosure is given.

12 Experience shows that from time to time and for varying reasons deficiencies in accounting standards appear. Following a recommendation in the Dearing Report, the Board has established a sub-committee called the Urgent Issues Task Force ("the UITF") to resolve such issues on an urgent basis in appropriate cases. The members of the UITF include leading members of the accountancy profession and of the business community. The agenda of the UITF is published in advance to allow for public debate. The UITF's consensus pronouncements (contained in abstracts) represent the considered views of a large majority of its members. When the UITF reaches its view, it is considered by the Board for compliance with the law and accounting standards and with the Board's future plans. If an abstract meets these criteria the Board expects to adopt it without further consideration. It will then be published by the Board.

The expectation of the CCAB, the Board and the profession is that abstracts of the UITF will be observed. This expectation has been borne out in practice. Accordingly in my view, the Court is likely to treat UITF abstracts as of considerable standing even though they are not envisaged by the Companies Acts. This will lead to a readiness on the part of the Court to accept that compliance with abstracts of the UITF is also necessary to meet the true and fair requirement.

13 The Joint Opinions were particularly concerned with the effect of standards on the concept of true and fair. The approach to standards taken in the Joint Opinions is consistent with the approach of the Court in *Lloyd Cheyham v. Littlejohn [1987]* BCLC 303 at 313. In that case Woolf J. (as he then was) held that standards of the ASC were "very strong evidence as to what is the proper standard which should be adopted".

14 As regards the concept of true and fair, I would emphasise the point made in the Joint Opinions that the true and fair view is a dynamic concept. Thus what is required to show a true and fair view is subject to continuous rebirth and in determining whether the true and fair requirement is satisfied the Court will not in my view seek to find synonyms for the words "true" and "fair" but will seek to apply the concepts which those words imply.

15 It is nearly a decade since the Joint Opinions were written. Experience and legislative history since then have both illustrated the subtlety and evolving nature of the relationship between law and accounting practice. Accounting standards are now assured as an authoritative source of the latter. In consequence it is now the norm for accounts to comply with accounting standards. I would add this. Just as a custom which is upheld by the courts may properly be regarded as a source of law, so too, in my view, does an accounting standard which the court holds must be complied with to meet the true and fair requirement become, in cases where it is applicable, a source of law in itself in the widest sense of that term.

Mary Arden

Erskine Chambers
Lincoln's Inn
21st April 1993

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