

**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 Hoffman Q.C. (now the Right Hon. Lord Justice Hoffman). [See below]
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 in 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:-*

“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

* 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.

the Review Panel is normally public and large private companies, with the Department exercising its powers in other cases.

7. The changes brought about by the Companies Act 1989 will in my view affect the way in which the Court approaches the question of 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 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 *standard* 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 the 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