THE FINANCIAL REPORTING COUNCIL

International accounting standards and the true and fair view.

A. Introduction

1. I have been asked by the Financial Reporting Council, for which I wrote an Opinion on 21st April 2008 entitled "The True and Fair Requirement Revisited", to consider an Opinion written by George Bompas QC on 8th April 2013.

2. In his Opinion Mr Bompas addresses a number of points that are important to preparers of accounts, to investors and to the accountancy profession. The Bompas Opinion has two main themes running through it.

3. First, with specific reference to the true and fair override, he considers the interaction of International Accounting Standards ('IAS') and the legal requirement in section 393 of the Companies Act 2006 ("the Act") that directors should only approve accounts (whether using UK GAAP or IAS Accounts) showing a true and fair view of the assets, liabilities, financial position and profit or loss of a company or a group of companies.

4. Second, he considers the place of prudence as an ingredient of the true and fair view, its current use in IAS and the implications of a decision by the International Accounting Standards Board ("the IASB") to cease to use the word prudence in the Conceptual Framework for Financial Reporting, 2010 ("Conceptual Framework").

B. The Principal Legal Considerations

5. Much of the black letter legal architecture surrounding these issues is not in debate. Nevertheless I set them out here.

6. Section 393(1) of the Companies Act 2006 ("the Act") requires that directors only approve accounts which give a true and fair view of the assets, liabilities, financial position and profit and loss of the company[1]. If annual accounts are approved which do not "*comply with the requirements of this Act*" the directors are guilty of an offence. Under Section 393(2) an auditor in carrying out his functions must have regard to the directors' duty under Section 393(1). The requirement under Section 393(1) is overarching and does not make any distinction between Companies Act individual accounts and IAS individual accounts, which by Section 395 a company may choose to use[2].

7. Section 396 of the Act in relation to Companies Act individual accounts repeats the true and fair view requirement, whereas there is no such repetition for IAS individual accounts. Section 397 requires directors to state that the accounts have been prepared in accordance with international accounting standards.

8. International accounting standards are defined by Section 474(1) as those within the meaning of the IAS Regulation (1606/2002/EC) which have been adopted, from time to time, by the European Commission in accordance with the IAS Regulation.

9. The IAS Regulation by Recital 9 states as follows:

"To adopt an international accounting standard for application in the Community, it is necessary firstly that it meets the basic requirement of the aforementioned Council Directives[3], that is to say that its application results in a true and fair view of the financial position and performance of an enterprise – <u>this principle being considered in the light of</u>

---

[1] In this Opinion, unless I make clear to the contrary, my conclusions in relation to individual accounts apply to group accounts.
[2] Article 4 of the IAS Regulation (1606/2002/EC) mandates use of IFRS for certain consolidated accounts.
[3] That is, the Fourth Directive (78/660/EEC) and Seventh Directive (83/349/EEC) and others, which are to be consolidated into the new Accounting Directive (2013/34/EU)

the said Council Directives without implying strict conformity with each and every provision of those Directives; secondly that, in accordance with the conclusions of the Council of 17 July 2000, it is conducive to the European public good and lastly that it meets basic criteria as to the quality of information required for financial statements to be useful to users" (Emphasis added).

10. The endorsement criteria are set out in Article 3(2) in the IAS Regulation as follows:

"The international accounting standards can only be adopted if:

- they are not contrary to the principle set out in Article 2(3) of Directive 78/660/EEC and in Article 16(3) of Directive 83/349/EEC[4] and are conducive to the European public good and,

- they meet the criteria of understandability, relevance, reliability and comparability required of financial information needed for making economic decisions and assessing the stewardship of management".

11. A number of IAS have been adopted as being compliant with those criteria[5]. One of those is IAS 1 which sets out *"overall requirements for the presentation of financial statements, guidelines for their structure and minimum requirements for their content."* It is the standard to be applied in preparing and presenting general purpose financial statements in accordance with IFRS, but acknowledges that other IFRS *"set out the recognition, measurement and disclosure requirements for specific transactions and other events"*.

12. IAS 1, Paragraph 15 is important to this debate and provides as follows:

"Financial statements shall present fairly the financial position, financial performance and cash flows of an entity. Fair presentation requires the faithful presentation of the effects of transactions, other events and conditions in accordance the definitions and recognition criteria for assets, liabilities, income and expenses set out in the Framework. The application of IFRSs, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation."

Self-evidently, the IFRS is the means, and fair presentation is the end.

13. Given the endorsement criteria set out in paragraph 10 above, it must follow that unless and until the European Court of Justice rules that an IFRS was adopted in breach of the

[4] That is, to give a true and fair view

[5] Standards are subject to an extensive consultation and consideration process prior to adoption by the EU – involving detailed review by EFRAG, the ARC and the European Parliament.

endorsement criteria, there can be no tension between Section 393 and Section 397. Directors who prepare accounts in accordance with IFRS are entitled to approve those accounts as giving a true and fair view.

14. IAS 1 in paragraph 17 goes on to give substance to the idea of a fair presentation. It provides as follows:

> *"In virtually all circumstances, an entity achieves a fair presentation by compliance with applicable IFRSs. A fair presentation also requires an entity:*
>
> *(a) to select and apply accounting policies in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors. IAS 8 sets out a hierarchy of authoritative guidance that management considers in the absence of an IFRS that specifically applies to an item.*
>
> *(b) to present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information.*
>
> *(c) to provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance".*

15. It goes on to allow departure under Paragraph 19 in these terms:

> *"In the extremely rare circumstances in which management concludes that compliance with a requirement in an IFRS would be so misleading that it would conflict with the objective of financial statements set out in the Framework, the entity shall depart from that requirement in the manner set out in paragraph 20 if the relevant regulatory framework requires, or otherwise does not prohibit, such a departure".*

The Framework referred to is the Framework for the Preparation and Presentation of Financial Statements approved by the IASB in July 2001 ("the Framework").

16. IAS 1 also deals in Paragraph 20 with what must be done in those circumstances. It requires, amongst other things, disclosure that the entity "*has complied with applicable IFRSs, except that it has departed from a particular requirement <u>to achieve a fair presentation</u>*" (emphasis added).

17. IAS 1 also considers the possibility that the relevant framework prohibits such departure, and in paragraph 23 what must be done in that case. That includes "*for each period presented, the adjustments to each item in the financial statements that management has concluded would be necessary <u>to achieve a fair presentation</u>*" (emphasis added).

18. Paragraph 24 of IAS 1 sets out what is meant by conflicting with the objective of financial statements as "*when it does not represent faithfully the transactions, other events and conditions that it either purports to represent or could reasonably be expected to represent*" and imports a materiality test by continuing "*and, consequently, it would be likely to influence economic decisions made by users of financial statements*".

19. It is important to note that the European Union adopted the latest version of IAS 1 in 2012 and that that version refers to the Framework, and not to the Conceptual Framework. Consequently, it is the Framework to which reference should be made when interpreting IAS 1, paragraphs 15 et seq. - not the Conceptual Framework. Accordingly, unless and until the European Court of Justice rules that accounting standards adopted by the EU pursuant to the IAS Regulation do not permit a true and fair override, there is no necessary tension between Section 393 and Section 397.

20. Finally, I would note that the conclusions of the Hoffman/Arden Opinions as to the approach that a court would take to accounting standards when considering whether accounts show a true and fair view remain equally valid when the question is posed in relation to the requirement of fair presentation and the use of IFRS.

<u>C. Mr Bompas's Conclusions</u>

21. Mr Bompas's central concern is the interaction between (i) international accounting standards as promulgated by the IASB, together with the framework for accounts using such standards, and (ii) the statutory requirement that accounts of a company, whether using UK GAAP or international accounting standards, must show a true and fair view of the assets, liabilities, financial position and profit and loss, as required by Section 393.

22. That concern arises because he perceives a particular difficulty for directors where the use of an adopted IFRS would fail to give a true and fair view as required. This would be a concern if the relevant accounting framework did not permit a true and fair override – because, without such an override, a director could not both comply with his duty under Section 393 (only to approve accounts that show a true and fair view) and, also, make the statement required by Section 397 (that the accounts have been prepared in accordance with adopted international accounting standards). Mr Bompas considers that the tension between these two requirements may place directors in a difficult position. However, there could be no basis for such concern if either (i) the use of adopted international accounting standards does produce a true and fair view or (ii) , if they do not, a true and fair override exists and so enables a company to produce IAS accounts that show a true and fair view.

23. Against this background, Mr Bompas was asked[6] whether adopted international accounting standards could satisfy the true and fair requirement where

(a) IFRS fail to include the capital maintenance purpose of which reserves are distributable and which are not,

(b) IFRS fail to require prudence as a fundamental accounting principle,

(c) the failure of IFRS to follow statutory accounting principles (i) in IAS 39 allowing unrealised mark to market or mark to model profits contrary to Article 31(1)(c)(aa) of the Fourth Directive and (ii) in IAS 39 and others in the approach to provisioning contrary to Article 31(1)(c)(bb) of the Fourth Directive.

24. To this question Mr Bompas answered (at para 11) that **if** the adopted international accounting standard had the results specified **and if** international accounting standards did not permit a true and fair override then they would not give a true and fair view.

[6] See para 10 of the Bompas Opinion

25. Mr Bompas then considers the questions set out paragraph 23 above.

a. He concludes that where accounts do not allow a user to distinguish between realised and unrealised profits, they would not give a true and fair view[7]. He considers that to be the view of the Court of Appeal in Bairstow v Queen's Moat Houses plc [2001] 2 BCLC 531.

b. He considers that prudence is a statutory ingredient of the true and fair concept which is deeply engrained as a necessary element of accounts giving a true and fair view. He describes its disappearance overnight as a seismic shift in the content of the true and fair view concept. Although he does not say so, the implication is that, in his view, any accounting standard or framework that does not recognise prudence would be incapable of giving a true and fair view.

c. He says that if it requires the recognition of unrealised profits, IAS 39 would be inconsistent with Article 31(1)(c)(aa) (which provides that *"only profits made at the balance sheet date"* may be included in accounts), with the consequence that accounts that complied with IAS 39 would not show a true and fair view.

In relation to provisioning more generally, he concludes that where IFRS do not require provisioning, where UK GAAP under the Directives would have, any resulting accounts would be inconsistent with Article 31(1)(c)(bb) and so those accounts would fail to give a true and fair view.

26. Turning to the true and fair override, he says that if the relevant accounting framework referred to in IAS 1 is the Framework (rather than the Conceptual Framework) he is less confident than I that there is a true and fair override, and he describes it as "*questionable*" whether international accounting standards permit a departure from their requirements in order to give a true and fair view. The reasons given are

(a) the presumption in IAS 1, para 15, that the application of international accounting standards achieves a fair presentation,

[7] This conclusion would apply equally to UK GAAP accounts as IAS accounts, although in para 66 Mr Bompas appears to limit his observations to IAS accounts.

(b) "*in consequence*" there is no subservience to the true and fair concept and no articulated requirement, "*and quite probably no implicit*", requirement that IAS accounts should give a true and fair view and

(c) international accounting standards have moved away from the central principle, that of prudence, entailed by the true and fair concept.

He does, however, acknowledge that a true and fair override may exist if the objective of providing useful information is to be equated with achieving a fair presentation, but he does not then say whether he agrees with that equation

27. However, if the relevant framework is the Conceptual Framework, Mr Bompas is clear that it does not provide a route to a true and fair or fairly presentation override because, critically, the Conceptual Framework does not require prudence as a component of true and fair or fair presentation.

D. My Conclusions

28. In the following paragraphs I address the propositions in Mr Bompas's opinion in the order that they are set out in paragraphs 25 to 27 above.

Failure to show distributable reserves.

29. Mr Bompas concludes that a company's individual statutory accounts cannot give a true and fair view if they do not contain sufficient information to enable a user to distinguish between realised and unrealised profits and losses, and thereby fail to enable a determination of amounts which are lawfully distributable.

30. This proposition, if correct, would have far-reaching consequences. It is rare for such a distinction to be made in financial statements and it is highly improbable that, historically, the profit and loss balance on balance sheets have contained only realised profits. If Mr

Bompas is right it would follow that few, if any, accounts fell within the statutory definition of 'relevant accounts' which could be used to justify a distribution and, as a result, a great many distributions made by companies since 1982 would have been unlawful.

31. However, I do not consider that conclusion to be correct. The legislative position (so far as relevant) can be summarised as follows:

    a. A company may make a distribution only out of profits available for that purpose (section 830(1)). A company's profits available for distribution are its accumulated, realised profits less its accumulated, realised losses (section 830(2));

    b. The availability of distributable profits is determined by reference to a company's "relevant accounts" (section 836(2));

    c. A company's relevant accounts, save for two exceptions[8], are the last annual accounts (the requirements of which are set out in sections 837 to 839). They may be either IAS individual accounts or Companies Act individual accounts ;

    d. To meet the legislative requirements, such accounts must be "properly prepared" in accordance with the Act (section 837(2)), which means the accounts must comply with the true and fair requirement and, in the case of IAS accounts, the requirement to apply EU-adopted IFRSs.

32. As will be clear from the above, the Act draws a distinction between realised and unrealised profits in defining what profits may be distributed – but it does not provide that the accounts to be used as the basis for any distribution should specifically differentiate between distributable and undistributable reserves (as would be required if Mr Bompas's contention were supported by statute).[9] The Act uses the more general word 'profit' when

[8] That is where the accounts are interim accounts or initial accounts

[9] Nor did the Cohen Committee recommend the inclusion of a legal requirement to distinguish between distributable profits, notwithstanding the submission to which Mr Bompas refers in paragraph 29 of his Opinion.

considering whether a distribution can be lawfully made, a term which covers both realised and unrealised profits.

33. Recognising that dividends may only be made out of realised profits and to supplement the legislative provisions, the accountancy profession has produced extensive guidance on the approach to be taken when calculating distributable reserves. That guidance has been in existence since 1982, being updated to take account of changes in legislation and the introduction of IAS.

34. Mr Bompas does not dispute the proposition in that guidance that there is no legal requirement for a company to distinguish in its balance sheet between distributable and non-distributable profits – a proposition that has been repeated in the 1982 Guidance Note and its successors, notably Tech 07/03 and the current guidance, Tech 02/10 issued by the ICAEW and the Institute of Chartered Accountants of Scotland.

35. The current guidance in Tech 02/10 is, relevantly, as follows:

> "*2.16 In practice it may not be sufficient to determine the amount of realised profits simply by examining the relevant accounts as further enquiries may be necessary as to the composition of the various reserves included in the balance sheet. For example, certain reserves may include both realised and unrealised profits. As there is no legal requirement for a company to distinguish in its accounts between distributable and non distributable profits as such (see 2.25 to 2.27 below), companies should keep sufficient records to enable them to distinguish between those profits which are available for distribution and those which are not.*
>
> *Disclosure of distributable profits*
>
> *2.25 There is no requirement under law or accounting standards for financial statements to distinguish between realised profits and unrealised profits or between distributable profits and non-distributable profits. Para 2.16 above draws attention to the need for companies to maintain sufficient records to enable them to distinguish between those profits that are available for distribution and those which are not.*
>
> *2.26 The guidance at 2.16 above is likely to be of greater significance when reporting under IFRSs or using fair value accounting rules under UK GAAP than has previously been the case. One reason for this is that the restriction in the Accounting Regulations that only profits realised at the balance sheet date may be included in the profit and loss account does not apply in these cases.*

> 2.27 *It may be thought helpful to users of financial statements if there is an indication of which reserves are distributable but, as noted above, there is no legal requirement to do so. In some cases, there may be practical difficulties with providing such an analysis. For example, there may be uncertainties about whether certain profits are realised or unrealised. There is generally no need for directors to form a view on whether profits are realised unless they intend to utilise them to make a distribution."*

36. Mr Bompas asserted that the excerpt from that guidance that he quoted in paragraph 33 of his Opinion supported the proposition that accounts will not give a true and fair view if they do not enable a determination of distributable and undistributable amounts. In my view, that guidance does not support any such proposition – it does no more, and no less, than identify a circumstance where additional disclosure might be helpful.

37. Finally, in support of his proposition, Mr Bompas refers to Robert Walker LJ's decision in Bairstow v Queen's Moat Houses plc [2001] 2 BCLC 531. I do not agree that that decision is authority for the proposition that accounts should show what is distributable and what is not, nor am I satisfied that the Court of Appeal held the view ascribed to them.

38. The issue in the case was whether the company's accounts should have shown any profit - not whether a profit was distributable or undistributable. Robert Walker LJ's comments and endorsement (p543-544) of the comments of Nelson J at first instance were directed at the requirement that accounts should be properly prepared and show a true and fair view (hence the references to sections 226 and 227 and to Schedules 4 and 4A). His reference to section 270 is simply to make it clear that a company's power to pay dividends is based on properly prepared accounts.

39. This is also clear from the structure of the first instance judgment (2000 1 BCLC 549 where Nelson J in setting out the statutory code (p556) emphasises the importance of properly prepared accounts and to the precursor of section 830(1) rendering it unlawful to pay a dividend except out of profits available for the purpose. Nelson J makes no mention of a requirement to show on the face of the accounts which profits are realised and which are not. The passage to which Robert Walker LJ refers appears at p.564 in a paragraph headed "Insufficient Reserves" and starts with the sentence "The payments made by QMH in excess of the reserves it held were in clear breach of section 263(1) of the Act. There

may be difficulties in any given case in determining whether a payment is made out of capital....". In that case there were no such difficulties because it was clear on the face of the accounts that the payment of the dividend was in excess of the reserves available.

I do not ignore the fact that Nelson J refers throughout to distributable reserves but the proposition for which Mr Bompas relies upon the case as authority was simply never before the court. Accordingly, Robert Walker LJ's comments are not authority for the much narrower proposition that accounts must, in order to comply with that statutory code, distinguish between distributable and non-distributable profits. Nor do the remarks of Lord Oliver in Caparo Industries plc v Dickman [1990] 2 AC 605, made in the context of the scope of an auditor's duty of care, provide authority for such a proposition.

40. In my view, in the absence of any legislative requirement and bearing in mind the way in which a court will give weight to the usual practices of accountants informed by the authoritative guidance of publications such as Tech 02/10, a court would not conclude that individual accounts that fail to distinguish between distributable and non-distributable profits fail to give a true and fair view.

The failure to require prudence as a fundamental accounting principle

41. In his Opinion, Mr Bompas refers to prudence (i) as an integral element of the true and fair view and (ii) by reference to specific provisions in the UK legislation derived from the Fourth and Seventh Directives. The first is a general concept, a cast of mind as it were, whereas the second is a specific, and legally based, proposition.

42. In the context of IAS individual accounts, the domestic legislation (in the shape of the regulations derived from the Fourth and Seventh Directives) is irrelevant. Those regulations do not apply to IAS accounts and so it is inappropriate to contrast the detailed provisions under UK GAAP with IFRS. What amounts to a true and fair view for the purposes of UK domestic legislation takes its colour from the relevant accounting framework which that legislation has permitted a company to choose. When considering whether, as a legal matter, a company's accounts produced using applicable international

accounting standards as permitted by the Act show a true and fair view, a court will have regard to the IFRS and the relevant Framework and it will not set up a contrast with UK GAAP. As the Hoffmann/Arden opinions make clear there is room for more than one true and fair view, and that is particularly so where there are different accounting frameworks established by legislation[10].

43. Accordingly, I shall deal with prudence as a general concept.

44. As Mr Bompas explains in paragraph 25, in the UK, prudence as a concept derives from SSAP 2. That SSAP specifically confirms that prudence and other related concepts are practical rules which are capable of development and evolution as accounting thought and practice develop. Given that capacity for evolution, a change in wording, or even the retirement of the word, in the underlying accounting framework does not necessarily give rise to a conclusion that that framework cannot produce a true and fair view, or fair presentation.

45. SSAP 2 has been superseded by FRS 18, Paragraph 30 of which sets out the objectives against which the appropriateness of accounting policies is to be judged. These are relevance, reliability, comparability and understandability – a list which is uncannily similar to the requirement in Paragraph 17(b) of IAS 1 (see para 14 above). Prudence is seen as an aspect of reliability. It is described in these terms in FRS 18, paragraphs 37 and 38 as follows:

> "37. *Often there is uncertainty, either about the existence of assets, liabilities, gains, losses and changes to shareholders' funds, or about the amount at which they should be measured. Prudence requires that accounting policies take account of such uncertainties in recognising and measuring those assets, liabilities, gains, losses and changes to shareholders' funds. In conditions of uncertainty, appropriate accounting policies will require more confirmatory evidence about the existence of an asset or gain than about the existence of liability or loss, and a greater reliability of measurement for assets and gains than for liabilities and losses.*
>
> 38. *However, it is not necessary to exercise prudence where there is no uncertainty. Nor is it appropriate to use prudence as a reason for, for example, creating hidden reserves or excessive provisions, deliberately*

[10] In this context, it is noteworthy that it is accepted in the US that accounts prepared under the US accounting framework and standards, whilst markedly different in material respects, are 'fairly presented'.

understating assets or gains, or deliberately overstating liabilities or losses, because that would mean that the financial statements are not neutral and therefore not reliable".

46. Clearly there can be areas where prudence and neutrality, on one view of the word, might conflict. FRS 18 goes on to deal with this in para 43 in these terms:

"There can also be tension between two aspects of reliability – neutrality and prudence. Whilst neutrality involves freedom from deliberate or systematic bias, prudence is a potentially biased concept that seeks to ensure that, under conditions of uncertainty, gains and assets are not overstated and losses and liabilities are not understated. This tension exists only where there is uncertainty, because it is only then that prudence needs to be exercised. In the selection of accounting policies, the competing demands of neutrality and prudence are reconciled by finding a balance that ensures that the deliberate and systematic understatement of assets and gains and overstatement of liabilities and losses do not occur".

47. It is important not to overplay the apparent tension between prudence and neutrality. A paraphrase of this paragraph might be that in conditions of uncertainty one achieves reliability, which is the superior concept in the hierarchy, by applying caution to your judgments (which actually achieves neutrality because in such conditions there is no absolute objective answer) but excessive caution introduces bias and defeats neutrality and hence reliability.

48. In the Framework this truth is set out in paragraph 37 where it states:

"The preparers of financial statements do, however, have to contend with the uncertainties that inevitably surround many events and circumstances, such as the collectability of doubtful receivables, the probable useful life of plant and equipment and the number of warranty claims that may occur. Such uncertainties are recognised by the disclosure of their nature and extent and by the exercise of prudence in the preparation of the financial statements. Prudence is the inclusion of a degree of caution in the exercise of the judgments needed in making the estimates under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because the financial statements would not be neutral and, therefore, do not have the quality of reliability."

49. The Conceptual Framework has determined that there should be only two fundamental qualitative characteristics, described as relevance and faithful representation. The word

prudence does not appear. Instead neutrality is given greater emphasis. In paragraph QC 14 it was stated as:

"A neutral depiction is without bias in the selection or presentation of financial information. A neutral depiction is not slanted, weighted, emphasised, de-emphasised or otherwise manipulated to increase the probability that financial information will be received favourably or unfavourably by users. Neutral information does not mean information with no purpose or no influence on behaviour. On the contrary, relevant financial information is, by definition, capable of making a difference in users' decisions"

50. To my mind the key message in that paragraph is the reference to the prevention of manipulation; a concern which chimes with FRS 18 in its comments about conservatism and the attendant dangers of over provisioning or under reporting. The Conceptual Framework is emphatically not outlawing the application of common sense and caution in the judgments that inevitably need to be made in the production of financial statements.

51. The importance of the avoidance of manipulation is clear from the Basis for Conclusions section where at BC3.27 and BC3.28 it stated:

"BC3.27 Chapter 3 does not include prudence or conservatism as an aspect of faithful representation because including either would be inconsistent with neutrality. Some respondents to the discussion paper and exposure draft disagreed with that view. They said that the framework should include conservatism, prudence or both. They said that bias should not always be assumed to be undesirable, especially in circumstances when bias, in their view, produces information that is more relevant to some users.

BC3.28 Deliberately reflecting conservative estimates of assets, liabilities, income or equity has sometimes been considered desirable to counteract the effects of some management estimates that have been perceived as excessively optimistic. However, even with the prohibitions against deliberate misstatement that appear in the existing frameworks, an admonition to be prudent is likely to lead to a bias. Understating assets or overstating liabilities in one period frequently leads to overstating financial performance in later periods – a result that cannot be described as prudent or neutral".

52. This issue was discussed by the Chairman of the IASB, Hans Hoogervorst, in a speech given on 18th September 2012 entitled "The concept of Prudence: dead or alive". He made it very clear that the motivation for the removal was (a) convergence with US GAAP, which did not have a definition of prudence, and (b) that in practice, the concept of prudence was used as a pretext for what he described as "cookie jar accounting" and for income smoothing; that is effectively to under-report in good times and over-report in bad so that in good times performance is depressed but, more critically, in times of downswing

hidden reserves are released to increase earnings thereby over-stating profits and masking a deterioration in an entity's performance. However, Mr Hoogervorst used that speech to emphasise that the proper application of prudence, which he defined as "if in doubt, be cautious" was very much engrained in international accounting standards and gave a number of examples in IFRS[11]. He concluded his speech saying

"Yet, I have also demonstrated that the basic tenets of the concept of prudence are still vital for our work. Indeed, the exercise of caution is visible in many of our standards and is also an important issue in the development of new standards. Indeed, one might very well conclude that the old Concept is not dead, but alive and kicking indeed."

53. This was also the view of the IASB in its submission to the Parliamentary Commission on Banking Standards referred to in Footnote 26 of the Bompas Opinion. In that Footnote, Mr Bompas asks why "it was thought necessary to keep out of the Conceptual Framework the reference to and discussion of prudence which had been contained in the Framework". The reasons are set out clearly in paragraphs 49 to 52 above – the IASB decided to remove the reference to the concept of prudence because it was thought that all too often it had become a cover for bias in the form of excessive conservatism.

[11] The examples given by the Chairman of IASB were as follows:

"o While fair values are often seen to be synonymous with exuberance, in IFRS 13 we actually require risk adjustments when fair values are measured using mark-to-model techniques.

o Our standards require liabilities to be recorded for guarantees or warranties, even when they have not yet been called in.

o Inventory is typically carried at lower of cost or net realisable value; again a prime example of exercising caution.

o Impairment tests are required to ensure that the carrying amount in the statement of financial position is not greater than the recoverable amount of the asset

o IFRSs also have very strict rules governing the balance sheet presentation, giving little room for off-balance sheet financing.

o As is well known, our standards are quite restrictive in terms of the netting of derivatives. The difference with entities reporting under US GAAP can be as big as 30 or 40% of the balance sheet. We believe derivatives are too important –and their net positions too volatile-to be relegated to the notes.

o The upcoming leasing standard is another effort to make off-balance sheet financing more transparent. Analysts around the world routinely adjust the balance sheet for leases that they perceive to be off-balance sheet financing. It is highly prudent that we are going to enshrine this in our standards.

o Equally, our consolidation rules, based on the principle of control are very strict. Rather than choosing for a bright line, we opted for a qualitative principle which may require consolidation, even if a company's interest is less than 50%."

54. That there has been no 'seismic shift in the content of the true and fair view concept' is further demonstrated by

a. The fact that the IASB has not reviewed or revised those standards prepared when the Framework was in place to take account of changes in wording in the Conceptual Framework

b. IAS 8, paragraph 10 – which expressly refers to prudence when an accounting policy is required because no standard exists to address a situation.

55. It is also noteworthy that the Accounting Directive, which was approved in June 2013, refers to prudence on a number of occasions.

a. Recital 9 provides that annual financial statements should be prepared on a prudent basis and give a true and fair view.

b. Recital 16 provides that the principles governing recognition and measurement should include prudence.

c. Recital 22 of the Accounting Directive sets out the correct approach to the use of estimates (an essential part of the preparation of financial statements and which involve judgments based on the latest available reliable information). The Recital states:

"This is especially true in the case of provisions, which by their nature are more uncertain than most other items in the balance sheet. Estimates should be based on a prudent judgement of the management of the undertaking and calculated on an objective basis, supplemented by experience of similar transactions and, in some cases, even reports from independent experts. The evidence considered should include any additional evidence provided by events after the balance-sheet date".

d. In Article 6 1(c) which requires items included in financial statements to be recognised and measured *"on a prudent basis".*

The Accounting Directive is, in my view, an unequivocal reaffirmation of the caution principle but without bias, which seems to me to be the essence of prudence as articulated in SSAP 2, FRS 18, the Framework and the Conceptual Framework.

56. It is also, in my view, important to bear in mind that the word itself is not of overriding importance. Although 'prudent' is used in domestic and European legislation, it is not totemic. 'Prudence' is an abstract concept – like 'true and fair' – and its content is capable of variation and evolution; its meaning will change and develop over time. What is important is the concept and behaviour that the language used is seeking to describe and mandate.

57. Given the clear retention of the idea of prudence in IAS by those responsible for the promulgation of standards, it would in my view be extraordinary if a court were to conclude that the removal of the word prudence from the Conceptual Framework led to a conclusion that accounts produced thereunder could not produce a true and fair view. The development of the Conceptual Framework should be seen as an example of the dynamic nature of the abstract concept of true and fair and the removal of the reference to prudence would be assessed in the context of the developing understanding of true and fair, including the rationale for the focus on neutrality (see paragraphs 41 et seq. above) .

58. However, I would go further than that. Even if a court were to conclude that prudence had disappeared altogether without trace, rather than had its proper meaning subsumed in neutrality, it will still not follow that accounts produced under the new framework could not produce a true and fair view.

59. One can test the proposition by considering what the position would be if it was decided to amend FRS 18 to accord with the Conceptual Framework by removing prudence. The Court would not be bound by some historic view of prudence. Nor would it be bound by the transposition of Article 31(1)(c)(aa) or (bb) into the Accounting Regulations for UK Companies. As the Hoffmann/Arden Opinion said:

"There are two further points to be considered. The first is the relationship between the "true and fair" requirement and the detailed provisions of the new Eighth Schedule[12]*. The Act is quite explicit on this point: the true and fair view is overriding. Nevertheless it may be said that the detailed requirements offer some guidance as to the principles which Parliament considered would give a true and fair view. In particular, the Schedule plainly regards historic cost accounting as the norm and current cost accounting as an optional alternative. In these circumstances, is a court likely to follow a SSAP which declares for certain companies, historic cost accounts cannot give a true and fair view? In our opinion, whatever reasons there may be for taking one view or the other, the provisions of the Eighth Schedule are no obstacle to accepting such a SSAP. As we have already pointed out, the provisions of the Schedule are static whereas the concept of a true and fair view is dynamic. If the latter is overriding, it is not impossible that the effect in time will be to render obsolete some of the provisions of the Schedule. But we think that this is what must have been intended when overriding force was given to a concept with a changing content."*

60. What is true for historical cost accounting and current cost accounting is true for prudence and neutrality. The dynamism of the concept in the sphere of IAS is in my view expressly recognised by the fact that the IAS Regulation in Recital 9 refers to the endorsement criteria of an IAS to meet the true and fair requirement of the Fourth and Seventh Directive without implying strict conformity with each and every provision of those Directives.

61. I would add, however, that in order to facilitate the adoption by the European Union of further standards developed in accordance with the Conceptual Framework, and given the concern apparently caused by the retirement of the word prudence, this debate could be avoided if the Conceptual Framework, when next published, were to confirm the importance and centrality of caution without bias, and expressly use the term 'prudence' when setting out the principles to be applied when matters to be reflected in the financial statements are uncertain.

The failure of individual IFRS to follow statutory accounting principles.

(i) IAS 39 and Article 31(1)(c)(aa)

62. Mr Bompas concludes that accounts prepared in accordance with IAS 39 cannot show a true and fair view if they produce a result that is inconsistent with Article 31(1)(c)(aa),

[12] Now the Accounts Regulations

because that provision does not permit the inclusion of unrealised profits in the profit and loss account.

63. However, this conclusion does not take account of

   a. The IAS Regulation, which specifically provides, in Recital 9, that it is not necessary for an adopted IAS to comply with each and every provision of the Fourth and Seventh Directives.

   b. The Accounting Directive[13], which expressly permits a deviation from Article 31 where fair value accounting is used. This permitted deviation finds expression in the UK in para 40(2) of Accounts Regulations (SI 2008/410).

These statutory provisions remove any possibility that the provisions of IAS 39 which permit mark to market or mark to model valuations to go through the profit and loss account, result in accounts that do not comply with the legislation and give a true and fair view.

64. Even if these provisions do not dispose of this conclusion, the choice of language in Article 31(1)(c)(aa) is important. That article refers to including profits *made* at the balance sheet date[14]. It is axiomatic that a profit can be made but can be either realised or unrealised.

65. As the proper yardstick under Article 31(1)(c)(aa) is the requirement that the profit be '*made*', I see no reason why a profit at a balance sheet date should not include profits that are unrealised. That being the case, the criticism of IAS 39 for permitting inclusion of unrealised profits on the ground that to do so is inconsistent with Article 31(1)(c)(aa) is misplaced.

[13] See Articles 8(8) and (9) of the Accounting Directive

[14] By contrast, paragraph 13 of the Accounts Regulations refers to profits *realised* at the balance sheet date. However, that provision is not relevant to the issue because it relates to a different legislative and accounting framework.

(ii) *IAS's failure to require provisioning in circumstances where UK GAAP under the Fourth and Seventh Directives would do so*

66. This criticism relates to IAS 39, but not only IAS 39, (i) not accounting for *"all foreseeable liabilities and likely losses irrespective of the time in which they arise"* [emphasis added], contrary to Article 31(1)(c)(bb) or (ii) not doing so where UK GAAP under the Fourth and Seventh Directives would have done so.

67. The first element of this criticism is, in my view, misplaced. Article 31(1)(c)(bb) of the Fourth Directive (as amended by Directive 2003/51/EC) refers only to account being *"taken of all liabilities arising in the course of the financial year concerned or of a previous one"* [emphasis added]. The effect of the Article is that only liabilities that have arisen at the balance sheet date are required to be recognised. The consequences of future events that are speculative or hypothetical are not required to be recognised.

68. The second element of this criticism rests upon the misplaced ground of assessing the statutory quality of true and fair by reference to UK GAAP rather than by IFRS, which is the permitted accounting framework in this context.

69. Further, and in any event, the tests under UK and European law are, to all intents, identical. Paragraph 13(b) of Schedule 1 to SI 2008/410 provides that *"all liabilities which have arisen in respect of the financial year to which the accounts relate or a previous financial year must be taken into account, ……"*. That is further confirmed in Appendix VI of FRS 12, which specifically states that *"there are no differences in substance between the requirements of FRS 12 and IAS 37"*.

The True and Fair override.

70. Mr Bompas suggests that my view that IAS 1 does provide a true and fair override should be re-visited in the light of the change in language between the Framework and the Conceptual Framework.

71. I should begin by explaining that I relied on Paragraphs 46 and 49 of the Framework in the context of my view that "present fairly" and "true and fair" are articulations of the same concept, when concluding (in paragraph 29):

"I add that, given the similarity of the subject matter and scope of each of the Framework and the Statement dealing as they do with reliability, comparability, fundamental accounting concepts and principal elements of financial statements in very similar ways, the conclusion would be that "true and fair" and "present fairly" were synonymous, <u>even if it were left unexpressed in the Framework</u>" (emphasis added).

I do not need to develop this view further as I do not understand Mr Bompas to disagree with it - the issue that Mr Bompas has raised is whether a true and fair, or fairly presents, override exists under the Conceptual Framework (or, for that matter, under the Framework).

72. It is important, when considering the legal issues raised by Mr Bompas, to bear in mind the nature, purpose and status of the documents being considered – the Framework and the Conceptual Framework. That purpose is explicitly set out in the Introduction to the Framework and in the Introduction to the Conceptual Framework – it is to *'assist'* the Board of the IASC or IASB, national standard-setters, preparers, auditors, users, and others generally. They guide the IASB in its development of standards. They guide accountants when there is no standard on an issue. But neither document constrains the IASB in its development of standards; nor do they provide a basis to depart from a standard otherwise than in accordance with IAS 1, paragraph 19. The IAS regulation provides that standards may only be adopted if they meet the criteria of *'understandability, relevance, reliability, and comparability"*. Those criteria are also used in the Framework, but the use of those criteria does not carry with it the implication that the IAS Regulation is bound by the remainder of the Framework or Conceptual Framework. In short, the Framework and the Conceptual Framework provide a context to the understanding and purpose of standards as opposed to a binding legal framework which must be complied with at all times.

73. My view can be shortly stated:

a. The objective of financial statements is that they should be useful (Framework, para 12; Conceptual Framework, para OB2);

b. To be useful, financial statements must be relevant, reliable, comparable and understandable (Framework, para 24; Conceptual Framework, para QC4);

c. For financial statements to be fairly presented, they must be relevant, reliable, comparable and understandable (IAS Regulation, article 3(2); IAS 1, para 17);

d. Departure from compliance with IFRS is permitted where that compliance would be so misleading as to conflict with the objective set out in the Framework/Conceptual Framework (IAS 1, para 19).

Therefore, when exercising the override contemplated by IAS 1, paragraph 19, a company must be satisfied that, if it did not do so, those financial statements would not be useful.

74. Before developing this analysis, I should explain that I do not share Mr Bompas's concerns at the absence of any reference to 'prudence' in the Conceptual Framework for two reasons:

a. First, because the version of IAS1 adopted by the EU refers to the 2001 Framework, and that version has not been amended to refer to the Conceptual Framework. As a result, there can be no debate as to whether 'prudence' has been, and remains now, a component of a true and fair view (or fair presentation) for the purpose of determining the application of the override in IAS1, paragraph 19.

b. Secondly, I would hold to that view even if the Conceptual Framework applied because, in my view, the change to refer to 'neutrality' has not resulted in the removal of the concept of 'prudence'. The Conceptual Framework developed the objective underlying the expectation that prudence would be used in preparing accounts to differentiate between the approach to be taken when the factual position is certain – neutrality – and when it is uncertain - prudence.

75. The ideas and concepts underpinning the Statement[15], the Framework and the Conceptual Framework are remarkably similar, albeit that as between the Framework and the Conceptual Framework there is some re-ordering of the hierarchy and amalgamation of concepts. Both the Framework and the Conceptual Framework define the objective of financial statements to provide information that is useful. The Statement does so in similar terms. Usefulness as a desideratum is fundamental to the concept of a true and fair view. This is clear from the first Hoffmann/Arden Opinion written in 1983 where, when considering why a court would have regard to the ordinary practices of professional accountants in deciding whether as a matter of law accounts give a true and fair view, they said this:

"...The important reason is inherent in the nature of the "true and fair" concept. Accounts will not be true and fair unless the information they contain is sufficient in quantity and quality to satisfy the reasonable expectations of the readers to whom they are addressed. On this question, accountants can express an informed professional opinion on what, in current circumstances, it is thought that accounts should reasonably contain. But they can do more than that. The readership of accounts will consist of businessmen, investors, bankers and so forth, as well as professional accountants. But the expectations of the readers will have been moulded by the practices of accountants because by and large they will expect to get what they ordinarily get and that in turn will depend upon the normal practices of accountants.

9. For these reasons, the courts will treat compliance with accepted accounting principles as prima facie evidence that the accounts are true and fair".

76. As accounts which are not useful to their readers will not be true and fair, I do not subscribe to the view that in this context usefulness has some qualitative separateness from true and fair, or fair presentation. And, this is reinforced by the fact that qualitative concepts which are common to European legislation, UK GAAP and IFRS - relevance, reliability, comparability and understandability - are harnessed for benefit of the readers of financial statements.

77. It follows from the intertwining of usefulness and true and fair, or fair presentation, that the observations made by Mr Bompas, based on the fact that the Framework or Conceptual Framework do not mention true and fair, or fair presentation, to the effect that the

[15] The Statement of Principles of Financial Reporting issued by the Accounting Standards Board in December 1999

objective of financial statements prepared under either framework is not to produce accounts that give a true and fair view or to provide a fair presentation, are misconceived.

78. This conclusion is re-enforced by the words of IAS 1, Paragraph 17(b). That paragraph's reference to providing information which is relevant, reliable, comparable and understandable is a direct reference to those concepts in the underlying frameworks and, by the terms of paragraph 17, those concepts are constituents of fair presentation.

79. Mr Bompas argues that IAS 1 does not provide a true and fair, or fair presentation override, because it refers in paragraph 19 only to a departure from IFRS where their application would be so misleading as to *'conflict with the objective of financial statements set out in the Framework'* and does not refer expressly to true and fair or fairly presents.

80. But that is to disregard the fact that IAS 1, by paragraph 19, clearly permits departure from IFRS and, even if one does not accept the analysis in paragraphs 73 to 78 above, the existence of such permitted departure must have a reason. That reason is discernible from the required explanations when there is a departure from IFRS. It is necessary to explain that a requirement has been departed from "*to achieve a fair presentation*" or, if departure is prohibited, it is necessary to set out the adjustments the management has concluded "*would be necessary to achieve a fair presentation*".

81. Finally, Mr Bompas relies on the fact that IAS 1, paragraph 15, provides that *"The application of IFRSs, with additional disclosure when necessary,* ***<u>is presumed</u>*** *to result in financial statements that achieve a fair presentation."* (emphasis added) as a reason for questioning whether IAS admit the possibility of a true and fair override. I take a different view. In my view that sentence is included to make it clear that more than slavish adherence to IFRS is required to achieve fair presentation. It seems to me to be no more than recognition of the evidential presumption made in the Hoffmann/Arden Opinion referred to above.

82. I accept that IAS does not use the direct language that would satisfy Mr Bompas[16]. However, where the express requirement of financial statements is, by paragraph 15 of IAS 1, to achieve fair presentation and the required explanation for departure from an IFRS is that departure was necessary in order to achieve fair presentation, there is simply no reasonable basis for denying the existence of a true and fair override.

Martin Moore

Martin Moore QC

Erskine Chambers

33 Chancery Lane

8th October 2013

[16] It is noteworthy that FRS 18 Accounting Policies in para 62 uses not dissimilar language to IAS 1