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True and Fair
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True and Fair

Introduction

The purpose of this document is to confirm that the true and fair requirement remains of fundamental importance in IFRS and UK GAAP, whether embodied in the new standards FRS 100 – 103 or the standards they replace.

Section 393 of the Companies Act 2006 requires that the directors of a company must not approve accounts unless they are satisfied they give a true and fair view. The true and fair requirement has been fundamental to accounting in the UK for many years. It is a requirement of both UK and EU law.¹

The introduction of IFRS in the UK did not change the fundamental requirement for accounts to give a true and fair view and the concept remains paramount in the presentation of UK company financial statements, even though the routes by which that requirement is embedded may differ slightly. Fair presentation under IFRS is equivalent to a true and fair view.

Concerns have been raised on the operation of the true and fair override in IFRS and the absence of the term “prudence” following changes made by the IASB in 2010 during the first phase of its Conceptual Framework project. However, these changes do not affect the fundamental importance of the true and fair requirement. Whilst terminology has changed, the true and fair override requirement still exists in the same substantive form and the absence of the term “prudence” in the 2010 Conceptual Framework does not prevent accounts prepared in accordance with IFRS from presenting a true and fair view.²

In this paper we discuss the continuing primacy of the true and fair requirement and its relevance to preparers, those charged with governance and auditors.

Preparation of accounts

Whilst there has been a gradual shift over time to more detailed accounting standards, the preparation of financial statements cannot be reduced to a mechanistic following of the relevant accounting standards. Objective professional judgement must be applied to ensure that financial statements give a true and fair view.

This professional judgement is all important. It applies at all stages of preparation of the accounts, for example:

- Where there is a choice of accounting policies allowed under accounting standards, ensuring that those selected are appropriate taking into account the circumstances of the company (see for example FRS 102 Section 10 and IAS 8).
- Establishing accounting policies for items not specifically covered by accounting standards or where they are ambiguous. In such circumstances the approach in

¹ The requirement that company and consolidated accounts give a true and fair view is recognised in Article 2 (3) of the 4th Company Law Directive and Article 16 (3) of the 7th Company Law Directive issued by the European Commission. Although these two Articles do not apply for accounts required to give a fair presentation in accordance with endorsed IFRS under the IAS Regulation, the true and fair principle underlying them is expressly recognised in Article 3(2) of the IAS Regulation – no IFRS standard can be endorsed if it would conflict with the principle set out in those Articles.

² The FRC has obtained two opinions from Martin Moore QC, one in 2008 and one in 2013 which are consistent with the analysis presented in this paper. Both Opinions are available on the FRC website.
IAS 8 to consider standards dealing with similar items may be appropriate; however reliance on an approved accounting treatment of a different kind of item will not necessarily give a true and fair view.

- Making judgements, for example about valuation, aimed at giving a true and fair view.
- Not using detailed accounting rules as an excuse for poor accounting
- Considering what is and what is not material.
- Giving appropriate disclosures even where not specifically required by accounting standards.
- Ensuring that significant information is not obscured by immaterial or irrelevant disclosures
- Standing back at the end of the accounts preparation process and making sure the accounts overall do give a true and fair view.

**Prudence**

For companies reporting under new UK GAAP, both FRS 102 Section 2 and company law require that directors make prudent judgements in their consideration of accounts, particularly where there is uncertainty.

IAS 8 requires that financial statements are prudent and “neutral, i.e. free from bias”\(^3\). These characteristics are not contradictory if, consistent with the 2010 Conceptual Framework, neutrality is seen as the absence of deliberate manipulation of financial information intended to make its reception by users more or less favourable. The inclusion of both characteristics reflects the fact that the use of excessive prudence, resulting in the deliberate understatement of assets or overstatement of liabilities, does not lead to useful information. As an example, hidden reserves or excessive provisions, which may be released later at will to boost profit, are not allowed.

The relative emphasis given to those characteristics that contribute to a true and fair view concept has, like the concept itself, evolved over time. Greater emphasis on neutrality reflects concerns about the smoothing of profits. In the first phase of its revisions to the IFRS Conceptual Framework in 2010, the IASB removed explicit references to prudence as the IASB considered that its inclusion may have led to greater bias. However, as part the second phase of its review of the Conceptual Framework, the IASB is now proposing to reintroduce an explicit reference to prudence though this is not expected to be finalised until 2015.\(^4\)

Irrespective of whether it is specifically included in the Conceptual Framework, the concept of prudence continues to underlie the preparation of accounts under both UK GAAP and IFRS through, for example, asymmetry in the recognition of profits when compared to losses and the measurement of assets and liabilities where uncertainty exists.

The importance of prudence in the development of IFRS was also confirmed by Mr Hoogervorst, Chairman of the IASB, who has said “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.”\(^5\)

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3 IAS 8 para 10 (b) identifies prudent and neutral as characteristics of financial statements that present reliable financial information.
4 See IASB Update May 2014 for a summary of the IASB’s tentative decisions on the Conceptual Framework revisions.
5 In a speech entitled “The concept of Prudence: dead or alive”, given in September 2012.
Reflecting the substance of transactions

IFRS and new UK GAAP, unlike the standards it replaces, do not contain separate standards that require accounts to reflect the substance of a transaction rather than its legal form where this is different. However, this does not mean that substance over form has no place in IFRS or new UK GAAP. It would be difficult for accounts to present a true and fair view if form had overridden substance.

IAS 8 states that for information to be reliable, it must be reported in accordance with economic substance, rather than strictly in adherence to its legal form. Indeed if material transactions are not accounted for in accordance with their substance it is doubtful whether the accounts present a true and fair view.

True and fair and accounting standards

True and fair is not something that is merely a separate add-on to accounting standards. Rather the whole essence of standards is to provide for recognition, measurement, presentation and disclosure for specific aspects of financial reporting in a way that reflects economic reality and hence that provides a true and fair view.

Accounting standards are arrived at after extensive consultation and after full due process. Further reviews are performed to ensure that IFRS meet the criteria for endorsement by the European Commission to ensure they would give a true and fair view.

These processes should result in accounting standards that, in the vast majority of cases, are complied with when presenting a true and fair view. The statement in IAS 1 that departures from the standards should only be necessary in “extremely rare circumstances” should be understood in the context of the consultation and other due processes that preceded the issue of the standards. It does not release directors from their legal obligation to only approve particular accounts if they are satisfied that they give a true and fair view and directors should not rely on it to avoid making appropriate judgements.

Disagreement with a particular standard does not, on its own, provide grounds for departing from it. Where the accounting standards clearly address an issue, but the requirements are insufficient to fully explain the issue, the solution is normally additional disclosure. For example, some companies have disclosed alternative measures, such as adjusted Earnings per Share measures, where such disclosures were considered necessary to provide a more complete picture of their performance.

However, where directors and auditors do not believe that following a particular accounting policy will give a true and fair view they are legally required to adopt a more appropriate policy, even if this requires a departure from a particular standard. As IAS 1 states, an entity cannot rectify inappropriate accounting policies by disclosure. These circumstances are more likely to arise where the precise circumstances were not contemplated during the development of the relevant standard.

IAS 1 paragraph 19 specifically requires departure from the requirements of a standard when compliance would conflict with the objective of financial statements. Concerns have been raised as to whether this continues to ensure standards are overridden in order to present a true and fair view. These concerns arose, in part, because the IFRS Conceptual Framework states that the objective of financial statements is that they should be useful and

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6 FRS 102 Section 2 requires the application of substance over legal form, noting that this enhances reliability.
7 FRS 102 Section 3 includes an equivalent requirement.
does not refer to the legal requirement that accounts present a true and fair view or are presented fairly. However such concerns are misplaced because:

- The concepts of usefulness and true and fair are, in the context of financial statements, inseparable - for financial statements to be useful they must present a true and fair view;
- IAS 1 para 24 explains that an accounting policy would conflict with the objective of financial statements “when it does not represent faithfully the transactions, other events and conditions that it purports to present or could reasonably be expected to represent”; and
- Where the true and fair override is applied, IAS 1 requires disclosure that the departure from a particular requirement is “to achieve a fair presentation”.

Where a company departs from a standard in order to give a true and fair view and a proper explanation is given of the reason for the departure and its effects, the Financial Reporting Review Panel will be reluctant to substitute its own judgement for that of the company’s board unless it is not satisfied that the board has acted reasonably. There have been examples where the override has been used under IFRS, both inside and outside the UK.  

**The approach to be taken by auditors**

The obligations of an auditor when giving an opinion on a company's financial statements are clearly set out in sections 393 (2) and 495 to 497, Companies Act 2006. Those obligations include stating whether, in their opinion, the accounts give a true and fair view (section 495 (3)(a)).

The importance of this approach is clearly recognised in ISA (UK & I) 700, in particular, in paragraphs 8, 9 and 11 (and supported in the application material in paragraphs A10 and A11).

Against that background, it is clear that if auditors are to discharge properly their legal and professional responsibilities, they should stand back as they approach finalisation of those accounts and consider whether, viewed as a whole and in view of the issues that they have addressed in the course of the audit, the accounts do indeed give a true and fair view.

**Conclusion**

It will be evident from the above that the FRC expects preparers, those charged with governance and auditors:

- Always to stand back and ensure that the accounts as a whole do give a true and fair view;
- To provide additional disclosures when compliance with an accounting standard is insufficient to present a true and fair view;
- To use the true and fair override where compliance with the standards does not result in the presentation of a true and fair view; and
- To ensure that the consideration they give to these matters is evident in their deliberations and documentation.

This will help ensure that accounts in the UK continue to demonstrate the high quality that users have come to expect.

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8 In the UK for example HSBC and National Express