The FRC's "True and Fair" paper (June 2014) falls short – A long-term shareholder perspective

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Context

Long-term shareholders have a strong interest in supporting a system of reporting that delivers a prudent view of companies' capital position, incentivises long-term stewardship of invested capital, and promotes stable and sustainable economic growth. While UK and EU Company Law require prudent accounts as a critical ingredient in the broader obligation for accounts that provide a "true and fair view", the signatories to this statement believe that the adoption of International Financial Reporting Standards (IFRS) – with its emphasis on neutrality over prudence – has dangerously weakened the implementation of true and fair accounting in practice[1].

The damaging impacts of this decision were clearly demonstrated in the financial crisis. Required to follow IFRS, banks were able to recognise gains prematurely (before they had been realised), and failed to adequately provision for foreseeable losses in their loan books. Profits were consequently over-stated feeding excessive bonuses, and inflating stated equity positions. A dangerous feedback loop was created, resulting in excessive (and overly risky) lending not supported by adequate equity, and fuelling the boom. When the true solvency risks became apparent, the cycle went into reverse. While the crisis had many contributory elements, the accounting rules played an insidious role.

The heart of the problem with IFRS – its goals differ to those in EU Company Law

We believe the reason IFRS has become disconnected from requirements for true and fair accounts as set out in EU Company Law is that IFRS accounts have different goals. Accounting requirements in EU Company Law are there to ensure directors are able to fulfil their legal duties to protect capital[2]. Specifically, company directors must be able to rely on accounts to ascertain the company's distributable reserves so that they are in a position to determine dividends that can be paid out without eating into capital. These rules are closely intertwined and mutually supportive. Critically, they reassure the providers of capital that the entity in which they are investing is solvent, and performance is not over-stated.

So, while true and fair may take on subjective meanings in common parlance, in Company Law it has a specific connotation: true and fair accounts must be prudent (excludes unrealised gains and include foreseeable losses) such that they do not over-state capital or performance, and ultimately ensure capital maintenance. The purposive nature of the true and fair requirement (i.e. that it delivers a reliable view of capital and distributable reserves) is confirmed in UK and European Court of Justice decisions, as well as QC Opinions[3]. QC Bompas (2013), in particular, points to the need for published accounts to show distributable reserves to deliver a true and fair view[4].

The most recent case heard by the ECJ is also very clear on the need to differentiate the realised from unrealised profits in true and fair accounts, since this is the basis for protecting capital. On the 3rd of October 2013 the ECJ's judgment on the State of Belgium vs GIMLE set out what the principle of "true and fair" under the Fourth Directive requires in terms of accounting. They conclude that a true and fair view is underpinned by

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[1] In line with EU law, since 2005 listed companies in the UK are required to use IFRS (endorsed by the EC) for Group accounts. UK and EU Company Law are very closely aligned in this area of Company Law. The statutory codifications of prudence in law is under the 4th Directive Article 31(1)(c). These include: 1) only realised profits can be booked, and 2) account must be taken of all foreseeable liabilities and potential losses arising in the course of the financial year or of a previous one, even if these become apparent between the balance sheet date and the date on which it is drawn up.

[2] Part 23, 2006 Companies Act

[3] Examples are covered by 2013 QC Bompas Opinion, 1983 Hoffman and Arden Opinion, Queen's Moat (House of Commons 2000), Caparo (House of Lords 1990), ECJ C234/94 Tomberger, ECJ C-275/97 Bauunternehmung, and ECJ C322/12 State of Belgium vs GIMLE

[4] See, specifically, para 34, QC Bompas (2013).

the principle of prudence, which in turn (under Article 31(1)(c)) prohibits the recognition of profits before they are "made" (i.e. realised). The principles and valuation rules are there to "protect members and third-parties". In brief, accounts are a vital part of the system of capital maintenance. Other uses are possible, but must not usurp the legal requirement[5].

In contrast, IFRS recognise a range of possible uses of accounts, and explicitly seeks to rise above any single accounting regime to provide a set of global standards. IFRS accounts are intended to provide information that is "useful in making economic decisions"[6].

The fundamental difference in goals for accounts between EU Company Law and IFRS helps explain why IFRS, as currently constituted, cannot be relied upon to meet capital maintenance requirements that are of vital importance to long-term investors.

In the case of banks noted above, the inability to clearly distinguish distributable reserves from un-distributable reserves in published accounts leaves investors unclear as to the banks' capital position. This uncertainty is still visible today, as market awaits the results of the ECB's Asset Quality Review with trepidation. Even the IMF has called for greater clarity over the true losses hidden in banks' balance sheets than those reported under IFRS[7].

The FRC's "True and Fair" paper of June 2014 falls short

In a Position Paper released originally in 2012, we set out why prudence is a vital accounting principal for long-term investors, and called for an independent review to establish whether action is needed to restore prudence to accounting in the EU[8]. In March 2013, we received a legal opinion, which supported our arguments that IFRS may deliver accounts that diverge from requirements under Company Law[9]. We have, as a group or individually, made submissions on the matter to various bodies, including the UK's Parliamentary Commission on Banking Standards and the European Commission.

Notwithstanding these contributions and evidence that the matter is being taken increasingly seriously by the European Commission and European Parliament, in June 2014 the UK Financial Reporting Council re-issued its paper of 2011 on "True and Fair". The paper reiterates the FRC's previous position that IFRS is consistent with Company Law. The paper fails to:

- **Provide clarity over what "true and fair view" means and – critically – how we know it has been achieved**. A broad reference to reflecting "economic reality" to ensure financial statements are "useful" are identified, but it does not mention the need for accounts to show distributable reserves to support Company Law requirements for capital maintenance, and to prevent distributions out of capital.
- **Make clear the availability of the true and fair "override" in the case where accounts do not reveal distributable reserves.** The FRC paper outlines the availability of an IFRS "override" to achieve a true and fair view, but (in part due to the lack of clarity over the meaning of true and fair noted above) indicates that in practice the override can only be used where accounts fail to comply with the IFRS Framework, rather than Company Law.
- **Clarify the key features of prudence in Company Law**. Namely, the requirement that foreseeable losses are recognised and the differentiation between realised and unrealised gains.
- **Mention the QC Bompas Opinion**, despite its significance as a respected legal opinion on the topic.

[5] Of course, additional information on current valuations may be disclosed, but the core accounts must reflect the principles of prudence, including foreseeable losses, and excluding unrealised gains.
[6] IASB, "*The Conceptual framework for financial reporting*", September 2010.
[7] IMF, "Global Financial Stability Report: moving from liquidity to growth-driven markets", April 2014.
[8] The original position paper was issued in July 2012, but has been updated. The latest version was released on 25th September 2013: "Concerns with IFRS in the EU – a long-term shareholder position paper".
[9] QC Bompas, "International financial reporting standards – Issues arising in relation to the Companies Act 2006", Lincoln's Inn, March 2013.

Action is required
In summary, we remain concerned that a faulty accounting framework, which has contributed to market instability and economic hardship in recent years, has not been properly addressed. We call upon the FRC to revise its "True and Fair" paper to deal with the four points above, and the European Commission to confirm the meaning of the true and fair view with regard to the vital goal of capital maintenance as defined in EU Company Law. We recognise that the International Accounting Standards Board is reluctant to set standards according to any particular legal construct, but would welcome efforts on its part to take account of the incompatibility that we identify for the EU[10]. If the IASB and the FRC cannot resolve the matter, there is an urgent need for a robust independent review.

[10] We welcome recent efforts by the IASB to revisit the status of prudence in the Conceptual Framework (see http://www.ifrs.org/Current-Projects/IASB-Projects/Conceptual-Framework/Documents/Effect-of-Board-decisions-DP-July-2014.pdf). However, without clarity over the rationale for why prudence is necessary – i.e. to ensure clarity of distributable reserves – there will continue to be uncertainty and debate over what level of prudence is required. In brief, we need to agree the purpose of accounts before we can agree the tools to fulfil the purpose.

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