INTERNATIONAL FINANCIAL REPORTING STANDARDS

(Issues arising in relation to the Companies Act 2006)

FURTHER OPINION

Introduction

1 On 8 April 2013 I gave an Opinion[1] concerning the requirement, for financial statements to give a "true and fair view", set out in s.393 of the Companies Act 2006, as well as in Article 2(3) of the Fourth Directive[2] and Article 16(3) of the Seventh Directive[3] (since then replaced by Article 2(3) of the Accounting Directive[4]). In that Opinion I discussed, in particular, and expressed doubt as to the extent to which there might be room for an overriding true and fair view requirement in the preparation of financial statements in accordance with adopted international accounting standards; and I examined the possibility of financial statements properly prepared in accordance with that framework ("IAS Accounts") failing to give a true and fair view.

2 Subsequently, in early October 2013, Martin Moore QC provided an Opinion for the Financial Reporting Council. This Opinion ("the Further Opinion"), dated 8 October 2013, was published at about the same time as two statements were made on the subject of the relevance of the true and fair view concept, in UK law, as regards IAS financial statements. Both of these statements were made on 3 October 2013. The first was made by Jo Swinson, the Minister for Employment Relations and Consumer Affairs, in the Department for Business, Innovation & Skills ("Department for Business"); the second was made by Baroness Hogg, the Chairman of the FRC.

3 The first of the two statements just referred to contained the following:

> *"In preparing financial statements, achieving a true and fair view is and remains the overriding objective (and legal requirement). In the vast majority of cases, compliance with accounting standards will result in a true and fair view. However, where compliance with an accounting standard may not*

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[1] In this present Opinion I use, for convenience, the same expressions with the same meanings as in my Opinion of April 2013.

[2] Fourth Council Directive of 25 July 1978 (78/660/EEC).

[3] Seventh Council Directive of 13 June 1983 (83/349/EEC).

[4] Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013.

> *achieve that objective, accounting standards expressly provide that that standard may be overridden".*[5]

The statement cites, in relation to IAS accounts, IAS1 para 19 as being the provision expressly providing for the override.

4 The second of the two statements, that by Baroness Hogg for the FRC, commented on the specific issue of the legality of the IAS reporting framework, saying as to this that the Department for Business "*today confirmed that the concerns expressed by some are misconceived;* and the statement continued:

> "*The FRC also agrees with the Department ... that, in preparing financial statements, achieving a true and fair view is the overriding objective. In the vast majority of cases this will be achieved by compliance with accounting standards. However, where compliance with an accounting standard would result in accounts that would be so misleading that they would conflict with the objective of financial statements, the standard should be overridden.*"

5 The Further Opinion was to similar effect as the statements just mentioned, and was indeed referred to in Baroness Hogg's statement as according with the FRC's view. It was also published by the FRC, no doubt to demonstrate the support for its view.

6 The purpose of my present Opinion is not to engage with each of the arguments made by Mr Moore in his Opinion. There are, nevertheless, two points which I have been asked to respond to. One concerns the overriding objective of achieving a true and fair view. The other, as an aspect of that, concerns the connection between that objective and the use of accounts for determining amounts which may properly be distributed to members by way of dividend.

<u>The overriding objective of achieving a true and fair view</u>

7 The view is expressed in the two statements just referred to, as well as in the Further Opinion, that the objective of IAS financial statements is to be equated with, as being the

[5] The statement cites, for accounts prepared under adopted international accounting standards, IAS1 para 19.

same as, the objective of achieving a true and fair view. The foundation for this view is paragraph 19 of IAS 1, referred to in the statement for the Department for Business.

8 In my Opinion I had discussed at some little length what is expressly stated in IAS1 para 19, and what its effect might be. The words used in that paragraph require departure from some IAS standard "*if the relevant regulatory framework ... does not prohibit such a departure*, the departure being "*in the manner set out in paragraph 20*". But, importantly, the departure is only permissible or required "*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*".

9 As I had pointed out in my previous Opinion, IAS1 para 19 makes no reference expressly to the achieving of a "true and fair view" as being the basis for a departure; and the point of reference in paragraph 19, namely the Framework[6] with its setting out of the objective of financial statements, likewise makes no reference to the giving of a true and fair view. Indeed, nowhere is there an express statement in the applicable standards in relation to the IAS reporting framework that an objective of IAS accounts is giving a true and fair view of the matters in CA06 s.393(1), the matters referred to now in recital (9) of the 2013 Accounts Directive, namely the assets and liabilities, financial position and profit or loss of the enterprise reported on.

10 In the Further Opinion Mr Moore had explained that the objective of financial statements as described is to provide information that is "useful". He then sought (at para 73) to equate the providing of information that is "useful" with achieving "a fair presentation" of information, and to equate achieving a "fair presentation of information" with giving a "true and fair view", leading to the conclusion that after all IAS1 para 19 provided for a

[6] In paragraph 72 of the Further Opinion Mr Moore states that an understanding of the "nature*, purpose and status*" of the Framework (and the Conceptual Framework) is important when considering the legal issues raised in my previous Opinion. However what Mr Moore explains about the nature, purpose and status of the documents does not detract from the point that according to IAS1 para 19 the objective of financial statements is that set out in the Framework, so that it is to the Framework that the reader of IAS1 is directed.

true and fair override, notwithstanding the absence of any mention of the expression "true and fair view" in IAS1 or, indeed, in the Framework to which IAS1 para 19 refers.

11 There is a flaw in the logic deployed by Mr Moore in his equating of the provision of information which is useful with the statutory requirement of giving of a true and fair view. His argument, at para 73 of his Opinion, is essentially that:

11.1 financial statements giving a fair presentation (proposition A) implies that the financial statements are relevant, reliable, comparable and understandable (proposition B), and

11.2 financial statements being useful (proposition C) implies that they are relevant, reliable, comparable and understandable (proposition B), so therefore

11.3 financial statements being useful (proposition C) and their giving a fair presentation (proposition A) are one and the same; and he adds that giving a fair presentation and achieving a true and fair view are identical, so that after all the objective of financial statements being useful is the same as their giving a true and fair view.

12 There are two immediate observations to make about this argument.

12.1 First, if the intention of IAS1 or the Framework had been for there to be a true and fair view override provided for in IAS1 para 19, the obvious way of fulfilling the intention would have been to use clear language, and not to set the reader the challenge of making the elaborate analytical exercise undertaken by Mr Moore.[7]

[7] As a further comment, the challenge posed for a person preparing, or relying on, IAS accounts is the fact that, as pointed out in my previous Opinion, there is distinct lack of clarity as to whether IAS1 para 19 was referring to the Framework, or the Conceptual Framework (paras 7 and 60 of that Opinion). In his Opinion Mr Moore hedges his bets by referring to both the Framework and the Conceptual Framework (eg in para 73 of his Opinion), while nevertheless opting for the Framework rather than the Conceptual Framework as still being applicable for IAS accounts, at any rate when arguing that the "prudence" concept still finds a place in IAS accounts (para 74(a) of his Opinion).

12.2 Second, the logic deployed by Mr Moore is defective: his fallacy is the common one of the undistributed middle. An example will make this clear. If I win the lottery (proposition A) I am happy (proposition B). If my child wins a scholarship (proposition C) I am happy (proposition B). But my winning the lottery and my child winning a scholarship are not the same. I may be happy for many reasons. The fallacy is to assume that proposition B implies both propositions A and C merely because each of those propositions imply B. Thus, as I pointed out in paragraph 54 of my Opinion, the objective of financial statements is not expressed in the Framework as being to achieve a fair presentation, so that it is difficult to extract from IAS1 para 19 that objective, much less the objective of giving a true and fair view, as the objective of financial statements. Rather, the objective is one of providing information which is "useful".[8]

13 This notwithstanding, it may be thought that in the UK, at any rate, the position has been reached where it will be said that achieving a true and fair view is an overriding objective of IAS accounts, and that IAS1 para 19 enables that objective to be paramount even where achieving it requires a departure from an accounting standard. This is because there is a widely held conviction, supported by the Government and by the FRC (most recently in the document "True and Fair" in accounting and reporting of June 2014[9]), that that is the true position, so that no directors or auditors will be open to criticism where they act in accordance with that principle; and, indeed, to disregard that principle in the preparation of accounts, even IAS accounts, in the UK would be brave.

[8] Para 45 of the Framework, referred to by Mr Moore, does indeed appear to equate the true and fair view concept with the fair presentation one. But this para also explains that the Framework "*does not deal directly with such concepts*".

[9] This document is introduced with the statement "*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*". It too cites IAS1 para 19 as establishing the relevant override in IAS accounts: "*IAS1 paragraph 19 specifically requires departure ...*", it being said that "*the concepts of usefulness and true and fair are, in the context of financial statements, inseparable.*"

14 Having said this, there still remains a concern. At paragraph 12 of his Opinion Mr Moore says "*Self-evidently, the IFRS is the means, and fair presentation is the end*". This is his comment on IAS1 para 15, which concludes with the sentence "*The application of IFRS, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation*". The difficulty is that if the adoption of the means is presumed to achieve the end, the end is simply the application of the means. Yet the contention in the two statements, those on behalf of the Department of Business and the FRC, referred to earlier in this Opinion, the assumption was made that the achieving of a true and fair view was the overriding objective which might not necessarily be achieved by application of the prescribed means and in such a case could require a departure from the prescribed means. It is by no means clear what yardstick is to be used for determining that a true and fair view has been achieved.

Distributions to shareholders

15 A fundamental question, in considering whether or not financial statements give a true and fair view of the relevant matters in relation to a company, will be the role the financial statements are to play in relation to dividend distributions. In my previous Opinion I drew attention to a criticism made of international accounting standards, namely that their application might not result in accounts which would enable the necessary determinations as to distributable amounts to be made for the purposes of Part 23 of the Companies Act 2006 (paras 66 & 67 of my previous Opinion). This criticism arises from the fact that international accounting standards "*are not primarily designed for [the] purpose*" of being "*used as the basis for profit distribution under the current capital regime of the 2nd Company Law Directive*"[10]. Relevant is a lack of linkage between the concept of realisation for distribution purposes and the concept of income recognition for reporting.[11]

[10] Para 1 of the Main Report of the KPMG Feasibility Study on Capital Maintenance (Contract ETD/2006/IM/F2/71).

[11] In the recent policy statement "Strengthening the alignment of risk and reward: new remuneration rules", PRA PS12/15 (and FCA PS15/16) there is a similar recognition of the limitation on the suitability of fair value accounting for purpose of measuring returns. Thus the PRA has determined that profit for the purposes of the awarding of remuneration by UK incorporated regulated firms is to be calculated "*on the*

16 This feature of the IAS accounting framework I mentioned as an area in which international accounting standards fall short of what is required for statutory accounts to give a true and fair view (para 64 of my previous Opinion). I also explained that, in the light of Part 23 of the Companies Act, accounts should show what is distributable and what is not if they are to give a true and fair view (paras 34 and 35 of my previous Opinion). This is because distributions are only to be made out of available profits (CA06 s.830(1)), such profits being "*accumulated, realised profits, so far as not previously utilised by distribution or capitalisation, less its accumulated, realised losses, so far as not previously written off ...*" (CA06 s.830(2)). Additionally, in the case of public companies, there is a restriction by reference to reported net assets (CA06 s.831). In each case the requirement is for a determination to be made (emphasis added) "*by reference to the following items <u>as stated in the relevant accounts</u>*", namely profits, losses, assets and liabilities, provisions of a specified kind, and share capital and reserves (including undistributable reserves).

17 Mr Moore has responded to this by arguing that there is no legislative requirement, as regards accounts required for the determination of what is distributable, for a distinction between distributable and non-distributable profits (para 40 of his Opinion). Essentially his point is that accounting profits need not be the same as distributable profits, that accounting profits may include unrealised (and therefore undistributable) profits. Therefore, according to Mr Moore, the determination of what is distributable is not after all to be by reference to specified amounts as stated in the relevant accounts, but by reference to those amounts to be found by some other way.

18 Essentially the proposition is that "*there is no legal requirement for a company to distinguish in its balance sheet between distributable and non-distributable profits*". And for this Mr Moore relies also upon guidance first given in 1982 by the Institute of Chartered Accountants in England and Wales and the Institute of Chartered Accountants of Scotland, which advised that because there is no such legal requirement "*companies*

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basis of prudent valuation principles in order to exclude unrealised profit from thinly traded or illiquid markets from being counted as profit to determine remuneration."

should keep sufficient records to enable them to distinguish between those profits which are available for distribution and those which are not".

19 The difficulty with this proposition is that it is simply not what was provided for by the Companies Act 1980, or by the replacement Companies legislation, all of which presupposes that properly prepared accounts will enable the user to determine what is distributable and what is not: the determination is to be by reference to amounts stated in the accounts, not by reference to amounts to be found by considering other "records" which might not be available to shareholders or creditors for whom the question of the relevant amounts might be highly material.

20 Before 1980 UK companies were subject to elaborate rules concerning what was and was not distributable. The essential principle was that distributions were not to be made out of capital, other than in specified cases. In the Report of the Committee on Company Law Amendment of 1945 ("the Cohen Report", Cmnd 6659) the view was expressed (at para 98) that a balance sheet's function would be to show various matters, including the reserves "*distinguishing those which are available for distribution as dividends from those not regarded as so available*". The inference is that, in principle, this was what was to be reported on by any balance sheet of a company which was to give a "true and fair view" in accordance with s.13 of the Companies Act 1948.

21 In 1980, in response to the Second Company Law Directive (77/91/EEC) Parliament enacted for UK companies the Companies Act 1980. That Directive had been directed at the adoption of provisions for maintaining capital by prohibiting reduction of capital by distribution. To this end, and ignoring as irrelevant to the immediate discussion what had been provided in that Directive concerning interim accounts, the Directive provided, by Article 15(1)(a):

> "... *no distribution to shareholders may be made when on the closing date of the last financial year the nets assets as set out in the company's annual accounts are ... lower than the amount of the subscribed capital plus those reserves which may not be distributed under the law or the statutes";*

and by Article 15(1)(c) that

> "*The amount of a distribution to shareholders may not exceed the amount of the profits at the end of the last financial year plus any profits brought forward*

and sums drawn from reserves available for this purpose, less any losses brought forward and sums placed to reserve in accordance with the law or the statutes".

22 Whatever may have been the position in the UK before 1980, when the Companies Act 1980 was brought into effect, from then on it would seem that the UK companies legislation has required distributions to be determined (emphasis added) "*by reference to the relevant items <u>as stated</u> in*" accounts (CA80 s.43(1))[12], the relevant items being (CA80 s.43(8)) "profits, losses, assets, liabilities, provisions ... share capital and reserves", reserves to include "undistributable reserves" within CA80 s.40. The relevant accounts for this purpose were to be the last annual accounts (subject to cases, irrelevant for the present discussion, where interim accounts could be used); and these last accounts had to be "*properly prepared*" (CA80 s.43(3)(a)), this expression meaning (CA80 s.43(8)) that they had been "*properly prepared in accordance with the Companies Acts*". As to this, the requirement was after 1980 and is now for such accounts to give a true and fair view if they are to be properly prepared.

23 The first of the matters in paragraph 21 above was dealt with in CA80 s.40. The reserves which, by CA80 s.40, were to be those not being capable of distribution, included share premium account and capital redemption reserve, and also most relevantly CA80 s.40(1)(c) "*the amount by which the Company's accumulated, unrealised profits, so far as not previously utilised by any capitalisation ... exceed its accumulated, unrealised losses, so far as not previously written off ...*". What, therefore, was to be capable of being determined by reference to matters stated in accounts for the purposes of the "net assets" test was the net unrealised profits (excess of unrealised profits over unrealised losses).

24 The second of the matters in paragraph 21 above was dealt with in CA80 s.39. This restricted distributions to "*profits available for the purpose*" and, broadly speaking,

[12] The equivalent in the Companies Act 2006, s.836(1), likewise requires the determination of the lawfulness of a distribution to be "*by reference to the [specified] items <u>as stated in</u>*" the relevant accounts.

defined these as (CA80 s.39(2)) “*accumulated, realised profits ... less accumulated realised losses.*”

25 As it seems to me, the language used in the Companies Act 1980 was clear, just as the language in the Companies Act 2006 is clear, in that as to the justification of distributions, where the last annual accounts are in point, what falls to be considered is the amount of specified items “*as stated in”* the accounts, resort to further supplementary records or documents not being required or permitted. It would follow that the contemplation of these provisions was and is that any realised profits (potentially distributable) would be an item separate and distinct from any unrealised profits (an undistributable reserve).

26 In the circumstances, so long as UK companies legislation relating to company distributions remains as it is at present, it seems to me to be difficult to assert that accounts which fail to enable a determination of what is or is not available for distribution by reference to amounts stated in them can give a true and fair view of a company’s assets and liabilities, financial position and profits or losses, as they will fail to meet one of the central purposes for which the accounts are required.

George Bompas QC

Lincoln’s Inn

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