Local Authority
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Forum

"SORRY, WRONG NUMBER"

POST MORTEM PART III

The implications for companies and regulation of the further opinion of George Bompas QC

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LAPFF has taken the highly unusual step of writing to all FTSE 350 listed companies setting out that in order to comply with the law, directors need to disregard certain statements by the 'regulator of financial reporting', the Financial Reporting Council (FRC).

In taking this step, LAPFF engaged specialist Queen's Counsel; in public law, Cherie Blair CBE, QC and Mr George Bompas QC, a specialist in company law, and Deputy Judge of the High Court.

Mr Bompas' first Opinion in 2013 concluded that there should not be any confusion in the standard to prepare statutory accounts, but there was confusion. [Ref 1]

Mr Bompas' further Opinion of August 2015 has dealt with the aftermath of his 2013 Opinion, in the light of further statements by the FRC and its counsel opinion from Martin Moore QC. [Ref 2]

It should not have had to take a leading QC in company law, under instruction from a QC acting for public pension funds, to point out that the financial reporting regulator is reading the basic legislation wrongly. But that is the essence of Mr Bompas' further opinion; the law is not as the FRC, nor Mr Moore, have said it is.

The mistaken position that results is that companies can keep two 'sets of books' in order to discharge the net asset and distributable profits tests of company law. But this leaves shareholders and creditors in the dark as to what the fundamental position relevant to solvency and lawful profits actually is.

Mr Bompas concludes that the problem flows from a defective interpretation of the law by the accountancy bodies, for which the FRC has regulatory oversight.

But the FRC, having been initially set up at less than full arm's length from the parties it regulates, has taken the defective position as a given.

A consistent theme of Mr Bompas' deconstruction of this defective position can be summarised as 'complicate, distract, confuse'.

That is 'complicate' the legal **standard** required of accounts, 'distract' from the legal **purpose** of accounts and 'confuse' **the target** of the law (i.e. wrongly imply that the standard applies as a broad brush to words, when the law applies its exactitude to **the numbers**).

On this last point LAPFF can observe that the FRC has no publications where it has even transcribed the law, Section 393 Companies Act 2006, correctly.

This leads LAPFF to conclude that elements of the accounting profession have sought to portray the law as something different to what it actually is, and parts of the accounting regulatory community have (at best) been taken in, in other words 'captured'.

That is why LAPFF, in its letter to members of the European Parliament, has written that, in LAPFF's view, the accounting profession had become 'a state within a state'. [Ref 3]

As long term investors this matters greatly because the result can be catastrophic for shareholder value when the basic numbers are wrong.

Problems include inadequate provisioning for bad debts (such as at UK banks) thus masking loss making business models, or the provision of reliably reported income (e.g. Tesco). The fundamental problem is not the share price resulting from defective accounts; the issue is the investee company operating the wrong business model based on the defective accounts.

THE CONCLUSION OF MR BOMPAS'S FURTHER OPINION

Mr Bompas' 2015 opinion not only reiterates that he believes that the position of the FRC (under the advice of its counsel Martin Moore QC) is wrong, but Mr Bompas also states precisely where he believes that the FRC and Mr Moore have gone wrong. Mr Bompas concludes.

> "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."

This is the precise opposite to what the FRC and Mr Moore have claimed. But in short, 'true and fair view' is the **standard** of **specified numbers as the target** for a central **purpose** - protection of members and creditors.

'Protection' means that the accounts are prepared to a standard sufficient to support a lawful distribution of profits and to ensure that net assets have not fallen below the amount of the share capital, i.e. the company is capital solvent.

A practical consequence of this position should be that reported profits actually exist, that all likely liabilities have been booked and that assets are not stated above their recoverable amount.

WHAT MR BOMPAS SHOWS AS WRONG

Despite a fundamental purpose of accounts being as straightforward as set out above, Mr Bompas identifies the following:

- IAS 1 (the foundation standard of the IFRS system) does not provide for the '**true and fair view'** standard that the legislation requires as the overarching requirement. Instead it uses the term to denote 'usefulness'.
- IAS 1 does not apply to the **specified numbers in the accounts** required by the legislation. Instead it applies to the far more broad brush construct of 'the accounts as a whole'.
- IFRS does not attach to the **same purpose as the legislation,** of creditor and shareholder protection. The objective is merely the non-concept of being 'useful'.

Mr Bompas also concludes that Institute of Chartered Accountants in England and Wales (ICAEW) technical guidance, relied on by the FRC and Mr Moore[1] is wrong due to incorrect reading of the clear legislation.

Determining whether the confusion has been deliberate or a product of wishful thinking and group-think isn't the main objective of this paper. However it is not possible to compare the opinion of Mr Bompas to the position of the FRC without raising the fundamental question of how on earth has this situation arisen?

DECONSTRUCTING THE CONFUSION - THREE BASIC ERRORS

The confusion Mr Bompas identifies boils down to the following errors:

1: the wrong standard - applying false logic
2: the wrong target - reading the legislation wrongly
3: the wrong purpose - reading the legislation wrongly

[1] In a press article (Accountancy Age) dated 19 October 2015, the FRC states 'In reaching its conclusions the FRC has not relied on the ICAEW'. However, UK-FRS 102 published in September 2015 states the following '*In determining profits available for distribution an entity may refer to Technical Release 02/10 Guidance on realised and distributable profits under the Companies Act 2006 issued by the Institute of Chartered Accountants in England and Wales and the Institute of Chartered Accountants of Scotland or any successor document, to determine profits available for distribution".* The FRC therefore is not merely relying on the ICAEW position it has given it a blank cheque to rely on it in perpetuity.

Error 1: the wrong standard – false logic

Mr Bompas concludes that the Moore Opinion for the FRC draws false equivalence between 'true and fair view' and 'usefulness'.

Mr Bompas demonstrates how Mr Moore's position is applying a well-known model of false logic. To illustrate, something that gives a true and fair view may be useful, but it does not follow that something that is useful, such as a tin opener, gives a true and fair view.

Mr Bompas is clear that the test of IAS 1 is merely to follow International Financial Reporting Standards (IFRS).

LAPFF notes that IAS 1 was personally drafted by Henry Benson (formerly Head of Coopers and Lybrand, a predecessor firm to PwC, and founder of the International Accounting Standards Committee).

Error 2: the wrong target – reading the legislation wrongly

Both UK and EU legislation requires a true and fair view of the entities' 'profit, loss, assets, liabilities and financial position'. However the FRC, in its papers on 'True and fair view' of 2011 and 2014, misquotes Section 393 of the Companies Act 2006. [Ref 4]

The precise text from the Companies Act is set out in the table opposite. The words that the FRC has left out are the words highlighted in grey.

The impact is subtle but profound, implying the 'true and fair view' standard applies in a broad brush way to the accounts as whole (including any narrative) rather than identifying that the numbers are correct. Thus the emphasis can shift to the **narrative being a way of making up for the wrong numbers**.

Section 393 states:-

"The directors of a company must not approve accounts for the purposes of this Chapter unless they are satisfied that they give a true and fair view of the assets, liabilities, financial position and profit or loss:

(a) in the case of the company's individual accounts, of the company;
(b) in the case of the company's group accounts, of the undertakings included in the consolidation as a whole, so far as concerns members of the company."

However the FRC does not transcribe this fully, thus allowing for a different interpretation, the FRC says:-

"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 FRC paper then goes on to create an even further abstraction, away from the correct position of the law, in addressing how auditors conduct their affairs, requiring their function to be one of

'Standing back at the end of the accounts process and making sure the accounts overall do give a true and fair view"

On the basis of what the FRC is saying, it is quite difficult to understand how auditors of companies, particularly banks, can ascertain whether the numbers are correct or not by 'standing back…at the end of the accounts process'. Common sense would suggest that the process to get the numbers right needs to be of primary importance, to be addressed upfront and thoroughly, not superficially at the end.

The FRC paper of 2011 was not signed by junior parties. It was signed by Mr Richard Fleck[2] (former chair of the Auditing Practices Board, which sets auditing standards for the UK and Ireland) and Mr Roger Marshall, Chairman of the UK Accounting Standards Board.

[2] LAPFF notes that Mr Fleck has been a non-executive member of one the FRC's constituent boards (or forerunners under self-regulation) since 1986. 29 years is more than three times the nine year tenure for which the UK Corporate Governance Code regards a non-executive director as no longer being independent.

Furthermore KPMG in giving evidence to the Parliamentary Commission for Banking Standards in 2013 on its audit of HBOS also gives an answer that is similarly inaccurate, in terms of what the legislation actually states as the preparation standard for accounts. [Ref 5]

Question: Did you have any concerns over the standard and transparency of the bank's disclosures? In your opinion, were these adequate to allow stakeholders to form a 'true and fair view' of the business?

Mr Guy Bainbridge, *KPMG "I do not recall being aware of any significant concerns regarding the adequacy of the disclosures in the financial statements during the period of my involvement with the HBOS audit.*

In forming our audit opinion in each year, we considered the adequacy of disclosures in the financial statements.

In providing an unqualified opinion each year we concluded at the date of the relevant audit opinion that the disclosures were sufficient that the financial statements taken as a whole presented a 'true and fair view'.

Error 3 – the wrong purpose – reading the legislation wrongly

The Moore Opinion for the FRC states there is not a legislative requirement for the accounts to enable a determination of distributable (i.e. real) profits. Mr Bompas is clear that it does. Mr Bompas identifies that not only is it a requirement of the Section 830 CA 2006 'distributable profits test, but there is also a requirement for the net assets test of Section 831 to show unrealised profits as undistributable reserves. [Ref 6]

Indeed, Mr Bompas demonstrates that the FRC position is relying on the defective position of the 1982 ICAEW Guidance. Not only is the position wrong, but it is wholly the result of the 'independent' regulator relying on an incorrect assertion **from the party it is supposed to regulate**.

In order to be consistent with the ICAEW position, Mr Moore (who also acts as advising counsel on company law matters for the ICAEW) states that because the distributable profits test refers to 'profits' in the plural, then for accounting purposes, profits in the plural can **conflate unrealised profits with realised profits**.

Mr Bompas identifies that this inference cannot hold as the subsequent Section 831 **puts unrealised profits in an entirely different place**, is as an undistributable reserve **as stated in the accounts**.

WHAT DOES IT TAKE FOR THERE TO BE SO MUCH CONFUSION?

Due to the various layers of UK, and now EU law, the level of confusion and error amount to more than reading the legislation wrongly. The purpose of accounts came from UK common law (case law). That was then codified into UK legislation in 1980 via and as a result of EU directives. To get this wrong in the wake of that legislative history requires:-

- misreading the UK legislation,
- and, ignoring the Recital to the Accounting Directive, which clearly sets out the legislative purpose behind the EU co-ordinating the requirements for statutory accounts,

Recital 3 of Council Directive 2013/34/EU (as in the prior fourth Directive of 1978) states

'The coordination of national provisions concerning the presentation and content of annual financial statements and management reports, the measurement bases used therein and their publication in respect of certain types of **undertakings with limited liability is of special importance for the protection of shareholders, members and third parties.**

Simultaneous coordination is necessary in those fields for such types of undertakings because on the one hand, some undertakings operate in more than one Member State and, on the other hand, **such undertakings offer no safeguards to third parties beyond the amounts of their net assets.'**

- and, failing to consider UK and EU case law, i.e. where the judiciary read the legislation, properly.

THREE PHASES OF CONFUSION – 'THE BENSON LEGACY'

Sufficient documentary evidence exists to build a picture of the way that particular people have worked at misrepresenting the law over the years.

Phase 1- Misrepresent what the law says

In LAPFF's view the confusion starts with misrepresentation of the law from the outset, i.e. misrepresenting what Parliament legislated in 1947. In respect of this LAPFF can identify Henry Benson as a consistent feature:

- he had tried to get onto the Parliamentary committee which drafted the legislative position (the Cohen Committee) as chairman, but in the event failed to get on that Committee at all [Ref 7], and,
- he was actively involved with the ICAEW Parliament and Law Committee (which interpreted legislation and lobbied on legal issues), even when not actually a member of it. [Ref 8], and,
- he gave a false and misleading picture to a Parliamentary Committee in 1982 as to what the original (1947) Companies Act said. He did this by misquoting the legislation, [Ref 9].

Against that background it is not too difficult to see how the ICAEW position and the 1982 ICAEW guidance might be defective.

Phase 2 - Set a defective parallel system. International Accounting Standard 1 (IAS 1)

Henry Benson personally wrote the final draft of IAS 1 in 1976 having taken it from the sub-committee that had been charged with drafting it, even though he was not actually a member of that sub-committee. [Ref 10]

In LAPFF's view his intended outcome, alongside the misrepresentation of the legislation, was to give the false impression that the standard for preparing accounts was merely one of following accounting standards, for which the objective was a wholly synthetic and spurious non-test of 'usefulness'.

Phase 3 - Misrepresent corporate governance, by making up auditor duties

It can also been seen that Benson's immediate successor as head of Coopers and Lybrand, Brandon Gough, followed in the footsteps of Benson by making up the law.

In submitting evidence to the Cadbury Committee in 1991 Mr Gough sets out how there needs to be a clear exposition of auditor duties as there is an 'expectation gap' i.e. the pubic expect more of auditors than the law requires. However, the true facts are that under the law there wasn't and isn't a gap. The only gap is one he tries to create by pretending that the law is different. [Ref 11]

The transcripts and outputs of the Cadbury Committee are consistent with Mr Gough's position not being believed. Similarly, decisions of the Courts, including this century, also run contrary to the positon that Benson and Gough were pushing.

Indeed, at the time that Brandon Gough was presenting this position, a fraud was beginning to be perpetrated in one of his firm's client companies, Barings Bank, by Nick Leeson which led to the catastrophic failure of the bank in 1995.

The High Court finding in the Barings case was clear, auditor negligence in not spotting the fraud when the loss had only been £1m had enabled the fraud going on inside the bank to get worse (including Barings plc London funding the losses in Barings Singapore that were passing off as profits). The legal expectation was that the auditor was accountable for the consequential losses arising to the bank as a result of the fraud, as well as dividends that had been paid that (due to the true financial state of Barings) were unlawful, and bonuses paid to staff on profits that did not exist. The only 'gap' was an auditor delivery gap. [Ref 12]

MORE RECENT EVIDENCE

This below is an insightful statement extracted from a paper that was presented to an ICAEW conference in late 2014. It was written by a former International Accounting Standard Board member from the UK who has also been a member of the UK Accounting Standards Board. The author, Professor Chris Nobes, is PwC Professor of Accounting at Royal Holloway College London. It confirms that codification of the law caused particular difficulty in the upper echelons of the UK accounting profession. [Ref 13]

> ***Extract***
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> *"A feisty attitude to the law became a long-running tradition for the leaders of the accountancy profession. However, in the field of financial reporting, it was necessary to become rather more subtle once the detailed accounting rules from the EU had entered British law in the Companies Act 1981. The UK standard-setters then used many devices to outsmart the law."*
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> Paper presented by Professor Nobes to ICAEW Conference 2014.

This paragraph has been excised from a later published version in 'Accounting and Business Research'. [Ref 14]

The very concept of "outsmarting the law" is odd as the financial reporting obligation in law is in fact a contract between the directors and the company on behalf of its shareholders and creditors, for their protection. The purpose and functions of accounts are set out in statute and in common law as well as by EU Directives. A consequence of the actions referred to in the Nobes statement above is that part of the FRC as 'regulator' has not merely been 'outsmarting the law' but not serving shareholders' interests.

WHERE MATTERS STAND

In the light of all of this, the FRC does appear to be little more than a victim of a regulatory catastrophe; in the invidious position of having represented the law wrongly due to having inherited false positions from the parties it purports to regulate.

Given this sorry state of affairs LAPFF has taken the unusual steps of

- writing to all UK FTSE 350 companies explaining that the position of the FRC should be disregarded in favour of the advice of Mr Bompas QC. Company directors literally cannot afford to be on the wrong side of confusion.

- Informing EU Commissioner Lord Hill and members of the European Parliament that the inaccuracies in the portrayal of UK and EU law in the UK has led to similar misrepresentation in Brussels of European law itself, leading to defective endorsement of IFRS by the EU. [Ref 15]

LAPFF's letter to Lord Hill of 23rd September 2015 identifies that all of the errors in reading UK law by the UK FRC, have been mirrored by the European Financial Reporting Advisory Group ('EFRAG' a body under the control of the accounting profession) in its reading of the relevant EU law in setting out how it is endorsing IFRS.

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