

# FINANCIAL REPORTING COUNCIL

TRUE AND FAIR

**JULY 2011** 

#### True and Fair

#### Introduction

The purpose of this document is to confirm that the true and fair requirement remains of fundamental importance in both UK GAAP and IFRS.

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 <sup>1</sup>.

The introduction of IFRS in the UK did not change the fundamental requirement for accounts to give a true and fair view. Indeed, for the avoidance of doubt, the FRC obtained an Opinion from Martin Moore QC in 2008 which confirmed that the true and fair concept remains paramount in the presentation of UK company financial statements, even though the routes by which that requirement is embedded may differ slightly. The Opinion also confirms that fair presentation under IFRS is equivalent to a true and fair view <sup>2</sup>.

In this note 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

In his Opinion Martin Moore notes, in relation to the gradual shift over time to more detailed accounting standards, that "It does not follow ... that the preparation of financial statements can now be reduced to a mechanistic process of following the relevant standards without the application of objective professional judgement applied to ensure that those statements give a true and fair view, or achieve a fair presentation."

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 (indeed, under UK GAAP, that they are the most appropriate), taking into account the circumstances of the company (see for example FRS 18 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 IAS 8 to consider standards dealing with similar items may be appropriate; however reliance on

<sup>&</sup>lt;sup>1</sup> The requirement that company and consolidated accounts give a true and fair view is recognised in Article 2 (3) of the 4<sup>th</sup> Company Law Directive and Article 16 (3) of the 7<sup>th</sup> 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.

<sup>&</sup>lt;sup>2</sup> The Opinion is available on the FRC website at: <a href="http://www.frc.org.uk/about/trueandfair.cfm">http://www.frc.org.uk/about/trueandfair.cfm</a>.

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 (see for example ASB Statement of Principles paragraph 3.29)
- Standing back at the end of the accounts process and making sure the accounts overall do give a true and fair view.

#### Prudence

For companies reporting under UK GAAP, both FRS 18 and company law require that directors make prudent judgements in their consideration of accounts, particularly where there is uncertainty

Both IFRS and UK GAAP now focus on the presentation of neutral financial information. As an example hidden reserves or excessive provisions, which may be released later at will to boost profit, are not allowed. The concept of prudence has evolved from the way it was applied in UK GAAP prior to the adoption of FRS 18 - greater emphasis on neutrality reflects a growing concern about the smoothing of profits. Similar considerations have also driven changes to the IFRS Conceptual Framework, to replace prudence with neutrality<sup>3</sup>. However, in practice the concept of prudence continues to underlie the preparation of accounts under both UK GAAP and IFRS. For example stocks, or inventories, are written down to net realisable value where it is lower - but not up where higher. Recognition of "Day 1 losses" is required but "Day 1 profits" are banned. Goodwill impairment tests are carried out on a prudent basis and judgements about the fair value of financial assets are not aggressive. As Mr Cooper of the IASB said4 "We are careful to make sure that profits are only recognised when they really are profits."

Whilst there are examples where UK GAAP gives rise to lower equity than IFRS the reverse is also true. The treatment of group pension schemes in subsidiary accounts is just one example.

<sup>&</sup>lt;sup>3</sup> Under FRS 18, neutrality and prudence are both aspects of reliability – in conditions of uncertainty prudence moderates neutrality, for example requiring more confirmatory evidence about the existence, and more reliable measurement, for assets and gains than for liabilities and losses. This is different from the revised IFRS Conceptual Framework which no longer refers to prudence as the IASB considered that it conflicts with freedom from bias.

 $<sup>^{\</sup>rm 4}$  in his evidence to the House of Lords Economic Affairs Committee in January 2011

# Reflecting the substance of transactions

UK GAAP contains a separate standard which requires accounts to reflect the substance of a transaction rather its legal form where this is different. The fact that IFRS does not contain a similar standard, and is more rules based than UK GAAP in some areas, has led some to express concern that substance over form has no place in IFRS.

This is not correct. 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. IAS 1 paragraph 19 requires an item to depart from an IFRS if it does not represent faithfully the transactions, other events and conditions it purports to, or could reasonably be expected to, represent.

## 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. As a result, in the vast majority of cases compliance with accounting standards will result in a true and fair view, and disagreement with a particular standard does not, on its own, provide grounds for departing from it. Indeed under UK GAAP almost all true and fair overrides in the past were of law rather than of a standard.

Where the accounting standards clearly address an issue, but the answer does not seem to accord with "common sense" in a particular case, the solution is normally proper disclosure. Indeed many companies have followed this route following the introduction of IFRS, for example stripping out the effect of IFRS hedge accounting restrictions in disclosing adjusted operating profits.

However in those 'extremely rare' circumstances 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 the 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 are not covered by a relevant standard

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 are a number of examples where the override has been used under IFRS, both inside and outside the UK.<sup>5</sup>

## 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).

The importance of this approach is clearly recognised in ISA (UK & I) 700, in particular, in paragraphs 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 our Boards expect 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 be prepared, albeit in extremely rare circumstances, to consider using the true and fair override; 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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Accounting Standards Board

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**Auditing Practices Board** 

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 $<sup>^{\</sup>rm 5}$  In the UK for example HSBC and National Express



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