THE FINANCIAL REPORTING COUNCIL

THE TRUE AND FAIR REQUIREMENT REVISITED

Opinion

1. I am asked to advise whether:

(a) the provisions of the European Directives and Regulations governing the preparation and audit of financial statements and/or

(b) the requirements of the Companies Act 2006 and, in particular, Sections 393-397 and Section 495 of that Act

require any revision to the approach to be taken to the concept of "true and fair" as articulated in the opinions of Leonard Hoffmann QC and Mary Arden written in 1983 and 1984 and by Mary Arden QC written in 1993 ("the Opinions").

2. Parts 15 and 16 of the Companies Act 2006 ("the 2006 Act") which deal with Accounts and Reports and Audit came into force, almost entirely, on 6th April 2008 and apply, with some limited exceptions, to accounting periods commencing on or after that date.

3. In this Opinion I will refer to the provisions now in force but my conclusions are the same in relation to the former provisions of the Companies Act 1985 as amended. References to the provisions of the 2006Act should be taken as references to the preceding equivalent provisions for the now limited period in which such provisions remain apposite.

4. In brief, and for the reasons which appear in this Opinion, my conclusions[1] are as follows:

(A) The central conclusions of the Opinions have been endorsed by the Courts in England, which will approach the true and fair requirement in the manner described in the Opinions (Paragraphs 11 -17).

(B) The decisions of the European Court of Justice ("ECJ") do not show a different approach and indicate that the ECJ supports the supremacy of the concept of the true and fair requirement and will adopt interpretations of the relevant Directives which avoid formalism (Paragraphs 18 – 21).

(C) The requirement set out in applicable international accounting standards to present fairly is not a different requirement to that of showing a true and fair view, but is a different articulation of the same concept (Paragraphs 23 – 29).

(D) Although the routes by which the requirement to give a fair presentation or a true and fair view have become embedded in relation to the financial statements of UK companies differ slightly in each case that requirement remains paramount (Paragraphs 30 – 35).

(E) The ability to depart from accounting standards (whether international or domestic) has been preserved, albeit by slightly different routes, if the result would be so misleading as to conflict with the objective of the relevant financial statements (Paragraphs 36 – 37).

(F) The scope for arguing that financial statements which do not comply with relevant accounting standards nevertheless give a true and fair view, or a fair presentation, is very limited (Paragraph 38 - 40).

[1] Save where expressly mentioned my conclusions are the same whether the accounts are single entity accounts or consolidated accounts.

(G) The preparation of financial statements is not a mechanical process where compliance with relevant accounting standards will automatically ensure that those statements show a true and fair view, or a fair presentation. Such compliance may be highly likely to produce such an outcome; but it does not guarantee it (Paragraphs 41 - 45).

(H) The true and fair view, or fair presentation, concept is of an overarching nature. Any decision made or judgment reached by the preparer of financial statements is not made in a vacuum but is made against the requirement to give a true and fair view, or to achieve a fair presentation (Paragraph 46).

(I) The concept comes into play, for example,

- in the way in which a standard is applied,
- in consideration of whether a standard should be departed from in those "exceptional" or "extremely rare" cases in which departure is permitted,
- in the choices regarding the applicability of a particular standard, or
- in determining the closest analogy where the circumstances are not precisely covered by a standard. (Paragraph 46 (A) – (E))

(J) The Transparency Directive's requirement to produce half-yearly reports showing a true and fair view does not change the analysis. It provides an example of how the requirement to give a true and fair view, or achieve a fair presentation, is in part moulded by the expectations of the users of financial statements (Paragraphs 47 - 53).

(K) The provisions of the Companies Act 2006, which have been asked to comment on particularly, have served to underline and reinforce the centrality of the true and fair requirement to the preparation of financial statements

(Paragraphs 54 - 57).

5. Given the time which has elapsed since the Opinions were written and the considerable developments in the area which have occurred in that period, it will take a little time to explain my conclusion. The approach I propose to adopt in this Opinion is as follows:

(a) First, to describe shortly the central conclusions of those opinions.

(b) Second, to consider any recent authority which may bear upon the issue.

(c) Third, to consider the relevant European Directives and Regulations both in their European context and in so far as incorporated into domestic law.

(d) Fourth, to consider the specific provisions of the 2006 Act upon which I have been asked to comment.

6. It must be remembered, however, that the above categorisation should not disguise the considerable degree of overlap between community and domestic law; not least because of the principle that domestic legislation should be construed so far as possible in conformity with the provisions and objectives of applicable Community law: *Marleasing SA v La Commercial Internacional de Alimentacion Case* C-106/89 [1990] ECR I-4135 and see *It's a Wrap (UK) Ltd v. Gula* [2006] 2 BCLC 634 for an application of that principle.

THE OPINIONS

7. The Opinions have achieved almost iconic status in their sphere of operation. The Opinions are reproduced in many professional publications and what follows should not be taken as substitute for reading them. However, for the purposes of this Opinion, I must attempt a distillation of them.

8. It seems to me that the essence of the Opinions is that:

(A) The requirement to prepare accounts which show a true and fair view was a legal requirement derived from both domestic legislation, namely Section 149 the Companies Act 1948, and Article 2(3) the Fourth Council Directive (78/660/EEC) which was incorporated into domestic law by the amendment of Section 149[2] of the 1948 Act.

(B) As a legal requirement, its satisfaction is a question of law for the Courts to determine.

(C) In determining that question, the Courts will rely very heavily upon the ordinary practices of professional accountants in determining whether accounts show a true and fair view. That is because those practices reflect the accumulation of experience and good professional practice and mould the expectations of the users of accounts as to the sufficiency and utility of the information in terms of quantity and quality.

(D) Compliance with generally accepted accounting principles as set out in relevant statements of standard accounting practice will be *prima facie* evidence of satisfaction of the true and fair standard and vice versa.

(E) The application of the concept involves judgment on questions of degree. Reasonable businessmen and accountants may differ over the degree of accuracy or comprehensiveness, there may be differences over the method used to adopt a true and fair view and there may be more than one view of a financial position, any of which could be described as true and fair.

[2] This became section 226and then 226A of the Companies Act 1985 and is now set out in section 396 of the 2006 Act

(F) The concept is dynamic, evolving and subject to continuous rebirth. Accordingly, the detailed provisions of the Schedules to the Companies Act may have to yield to the overriding requirement to produce accounts which give a true and fair view.

(G) The provisions of the Companies Act 1989 which provides, amongst other things, for (a) the establishment and funding of the FRC, (b) a statutory definition of accounting standards, (c) the requirement to state that accounts have been prepared in accordance with applicable standards with departure to be particularised and justified and (d) the mandatory revision of defective accounts on the application by the Secretary of State or its authorised person, the FRRP, have served to underline the central importance and authority of accounting standards to the production of accounts showing a true and fair view.

(H) These factors, together with the more inclusive process of standard setting, all serve to increase the likelihood that a Court would hold that compliance with a standard is necessary to meet the true and fair requirement.

RECENT AUTHORITY

9. The Opinions remarked that there were no reported cases on the specific question of whether accounts show a true and fair view, although the issue had been adverted to in cases on other matters. The Opinions did, however, note that there had been discussion in revenue cases on whether a profit or loss has been calculated in accordance with "the correct principles of commercial accountancy"[3], being those used when preparing accounts that show a true and fair view.

10. As can be seen below, since the Opinions were written, there have been some cases of relevance on the topic, both before domestic tribunals and the European Court of Justice ("ECJ") which have followed the reasoning that the Opinions expected the courts

[3] This approach was approved by the House of Lords in *HMRC v William Grant & Sons Distillers Limited* 28th March 2007 [2007] UKHL 15

to adopt.

The National Courts

11. The 1984 Opinion set out the approach of Pennycuick V-C in *Odeon Associated Theatres v Jones (Inspector of Taxes)* [1971] 1 W.L.R. 442 as an analogous guide to the approach a Court would take to the true and fair requirement. The approach of Pennycuick V-C was endorsed by the Court of Appeal in *Gallagher v Jones (Inspector of Taxes)* [1994] Ch. 107. Sir Thomas Bingham MR said at page 134:

> *"Despite the length of this judgment, the central issue is at root a very short one. The object is to determine, as accurately as possible, the profits or losses of the taxpayers' businesses for the accounting periods in question. Subject to any express or implied statutory rule, of which there is none here, the ordinary way to ascertain profits or losses of a business is to apply accepted principles of commercial accountancy. That is the very purpose for which such principles are formulated. As has often been pointed out, such principles are not static: they may be modified, refined and elaborated over time as circumstances change and accounting insights sharpen. But so long as such principles remain current and generally accepted they provide the surest answer to the question which the legislation requires to be answered. As Sir John Pennycuick V-C pointed out in Odeon Associated Theatres v Jones (Inspector of Taxes) [1971] 1 W.L.R. 442 different considerations arise where there is no accounting evidence or where there are two or more principles either or any of which is generally accepted. But these considerations do not apply here.*
>
> *The authorities do not persuade me that there is any rule of law such as that for which the taxpayers contend and that the judge found. Indeed, given the plain language of the legislation, I find it hard to understand how any judge-made rule could override the application of a generally accepted rule of commercial accountancy which (a) applied to the situation in question, (b) was not one of two or more rules applicable to the situation in question and (c) was not shown to be inconsistent with the true facts or otherwise inapt to determined the true profits of losses of the business"*

12. The House of Lords in *HMRC v William Grant & Sons Distillers Limited* 28th March 2007 [2007] UKHL 15 again adopted that approach and declined to find that some fundamental principle of accountancy demanded an answer different to that provided by that test.

13. In case Lord Bingham might be thought to be giving too much power to generally accepted principles of commercial accountancy, there has been a timely reminder in *Balloon Promotions Limited v. Wilson (Inspector of Taxes)* 3rd March 2006 SPC00524 (before a Special Commissioner) that the question of what constitutes compliance with the true and fair requirement remains a legal question. In that case the Special Commissioner was considering the meaning of goodwill for roll-over relief under section 152 of the Taxation of Capital Gains Act 1992. He was satisfied that the accountancy definition of goodwill was deficient. He said at p.35:

> *"The definition under SSAP 22 permits the possibility that intangible assets other than goodwill which cannot be separately identified and assessed to be categorised as goodwill. The central dispute in this appeal is about whether the consideration apportioned to goodwill should instead be apportioned to another intangible asset, namely compensation for the early termination of a franchise agreement. Thus goodwill should be construed in accordance with legal not accountancy principles."*

14. There have been some cases where the question of true and fair has arisen in the context of breach of warranty claims. In some of the cases, the relevant accounts have been distorted by fraudulent entries. In those cases, it is easy to demonstrate that the accounts do not show a true and fair view. These cases therefore do not illuminate the approach of the Court

15. The approach of the Opinions has been endorsed by the Court in *Bairstow v. Queen's Moat House PLC* (19th July 1999) by Nelson J where he says:

> *"In their joint opinion to the Accounting Standards Committee, Leonard Hoffmann QC and Mary H Arden (as they then were) expressed the view that the information contained in accounts must be accurate and comprehensive, that is, sufficient in quality and quantity to satisfy the reasonable expectations of the reader to whom they were addressed. They rightly anticipated that the courts would on this basis treat compliance with accepted accounting principles as prima facie evidence that the accounts were true and fair, and equally that deviation from accepted principles would be prima facie evidence that they were not (See Lloyd Cheyman v. Littlejohn [1987] BCLC 303). This view has now been*

> *strengthened by the Companies Act 1989 and subsequent regulation now make that more likely"*

16. An example of the acceptance by the Court of the points made in the Opinions, and summarised in paragraph 6(E) above, can be found in *Jeunique International Holdings Limited v. Foreshew* 2nd April 2001. This dispute concerned the valuation of fixed assets which were alleged to be overvalued such that the relevant warranty as to true and fair was wrong. It was found that certain assets should have been valued at net replacement cost but had been valued at gross replacement cost; in other words, not in accordance with the valuation rules in Part C of Schedule 4, Companies Act 1985. Nevertheless certain assets had been undervalued by at least as much as that overvaluation. Accordingly the line item in the audited accounts for Fixed Assets did give a true and fair view.

17. These authorities demonstrate that the approach to the true and fair requirement in the Opinions (as summarised at paragraph 6 above) has been affirmed by the English courts.

European Court of Justice

18. There have been two important cases before the ECJ on the compatibility with the Fourth Directive of, in both cases, German accounting rules. Both provide an insight into the approach that the ECJ takes to the requirement in the Fourth Directive that accounts should show a true and fair view.

19. The first, *Tomberger v. Gebruder von der Wettern* Case C -234/94 [1996] 2 BCLC 457, is instructive for the approach of the Court to the meaning of "true and fair view" in the Fourth Directive and the adoption by the Court of a flexible interpretation of the provisions of the Fourth Directive.

20. The second, *DE + ES Bauunternehmung GmbH v Finanzamt Bergeheim* Case C-275/97 [2000] BCC 757, construed the detailed provisions of the Directive against the yardstick of the true and fair requirement and, furthermore, subjected an exceptional case

departure to a true and fair requirement. Both these cases are discussed in detail in the Appendix to this Opinion.

21. These decisions of the ECJ do not suggest that there is any reason to change the approach to the true and fair requirement articulated by the Opinions. On the contrary, they demonstrate that the ECJ will, in supporting the supremacy of the concept, adopt interpretations of the relevant Directives in a manner which avoids formalism.

THE EUROPEAN DIRECTIVES AND REGULATIONS

22. Naturally, the Opinions were written against the backdrop of the Fourth and Seventh Company Law Directives and I do not, therefore, need to consider their impact, save to say that the decisions of the ECJ on the Directives have not shown that the approach is erroneous or that there is some divergence between the approach to the true and fair requirement between the domestic courts and the ECJ.

The IAS Regulation

'True and Fair' and 'Presents Fairly'

23. The Fourth and Seventh Directives stood for many years as the main harmonizing instruments in the accounting field. However, a further impetus to harmonisation has been given by the introduction of international accounting standards. The vehicle for such introduction on a community wide basis is Regulation 1606/2002 ("the IAS Regulation"), which provides for the procedure whereby International Accounting Standards ("IAS") are to be adopted and sets out the financial statements to which they must be applied. Broadly, the use of adopted IASs is mandatory for the consolidated accounts of listed companies whose securities are admitted to trading on a regulated market. It is important to note that the IAS Regulation provides that adoption of an IAS should not occur if to do so would be contrary to the true and fair requirements of the Fourth and

Seventh Directives: see art 3(1).

24. This is significant because the IAS 1 does not use the term true and fair, but instead uses the adverb "fairly". Paragraph 13 of IAS 1 provides as follows:

> *"Financial statements shall present fairly the financial position, financial performance and cash flows of an entity. Fair presentation requires the faithful representation of the effects of the transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the Framework. The application of IFRSs, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation"*

25. The Framework referred to in IAS 1 is a document prepared by the International Accounting Standards Board (the IASB) entitled Framework for the Preparation and Presentation of Financial Statements ("the Framework"). The Framework is designed to set out the concepts which underlie the preparation and presentation of financial statements for external users and assist the IASB in setting international accounting standards.

26. The Framework is similar in scope in to the Statement of Principles of Financial Reporting made by the Accounting Standards Board in December 1999 ("the Statement").

27. The Statement is more explicit in its references to the true and fair requirement than the Framework. The Statement contains this passage:

> *"12. It is inherent in the nature of the true and fair concept that financial statements will not give a true and fair view unless the information they contain is sufficient in quantity and quality to satisfy the reasonable expectations of the readers to whom they are addressed. Such expectations change over time and the Board seeks, through its accounting standards and other authoritative pronouncements, both to respond to those expectations and to influence them. The Statement of Principles may therefore be expected to contribute to the development of the concept.*

13. The Statement of Principles does not, however, define the meaning of true and fair – it is detailed legal requirements, accounting standards and, in their absence, other evidence of generally accepted accounting practice itself, that normally determine the content of financial statements. Nevertheless, as the Statement is a set of high level principles designed to help in setting standards, it has the true and fair view concept at its foundation. Its insistence on relevance and reliability as prime indicators of the quality of financial information is just one example of this"

28. In contrast, the Framework does not emphasise the true and fair concept in this way. It does, however, contain a passage which in my view makes it clear that "true and fair" and "present fairly" do not describe two different concepts, but are simply different articulations of the same concept. It says at Paragraph 46:

"Financial statements are frequently described as showing a true and fair view of, or as presenting fairly, the financial position, performance and changes in financial position of an entity. Although the Framework does not deal directly with such concepts, the application of the principal qualitative characteristics and of appropriate accounting standards normally results in financial statements that convey what is generally understood as true and fair view of, or as presenting fairly such information"

29. I add that, given the similarity of the subject matter and scope of each of the Framework and the Statement dealing as they do with reliability, comparability, fundamental accounting concepts and principal elements of the financial statements in very similar ways, the conclusion would be that "true and fair" and "present fairly" were synonymous, even if it were left unexpressed in the Framework. It is noteworthy that "present fairly" is very similar to "quadro fedele" or "image fidele" which are respectively the Italian and French translations of true and fair in the Fourth and Seventh Directives.

The manner in which accounting standards have been given legal effect

30. Pursuant to the IAS Regulation, the EC incorporated certain international accounting standards issued by the IASB (including IAS 1[4]) into European law by a series of regulations, each of which is binding on those preparing the consolidated

[4] Adopted by EC 1725/2003

accounts of listed companies whose securities are admitted to trading on a regulated market in the EC.

31. The position in relation to the preparation of

> (i) the group accounts of companies whose securities are not admitted to trading on a regulated market in the EC ('non IAS group accounts'), and
>
> (ii) the accounts of individual companies

was left to be addressed through national law.

32. The changes to the Companies Act 1985 necessary to incorporate the IAS Regulation into domestic law were made by the Companies Act 1985 (International Accounting Standards and Other Accounting Amendments) Regulations 2004 (SI 2004/2947). The greater part of the changes were those necessary to implement the IAS Regulation, but additional changes were made to implement both the Directive 2001/65/EC (the Fair Value Directive) and Directive 2003/51/EEC (the Accounts Modernisation Directive) as they affected the annual and consolidated accounts of certain types of companies, banks and other financial institutions.

33. The 2006 Act sets out, by section 395, introduced two types of individual accounts for companies; Companies Act individual accounts (which are to be prepared in accordance with section 396) and IAS individual accounts (which, by virtue of section 397, are to be prepared in accordance with IAS). By section 403, save for those cases in which group accounts must be prepared in accordance with IAS, a similar choice is available for group accounts.

34. It is important to note that section 397 requires a company which prepares IAS individual accounts to state in the notes to the accounts that they have been prepared in accordance with international accounting standards. This is similar to Paragraph 45 in

Part 3 of Schedule 1 to the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008[5] as regards preparation in accordance with applicable UK accounting standards. The audit report must state clearly whether in the auditor's opinion the annual accounts have been properly prepared in accordance with the Act or Article 4 of the IAS regulation i.e. in accordance with IASs and whether the accounts give a true and fair view of, or present fairly, in accordance with the relevant accounting framework.

35. Thus the legislative route is slightly different for Companies Act Individual Accounts and IAS Individual Accounts in that the former have an express incorporation of the true and fair requirement in section 396 and the latter have, by virtue of section 397 the requirement to achieve a fair presentation incorporated by reference. Nevertheless, in each case the relevant requirement is embedded into domestic law.

The circumstances when departures from accounting standards are permtited

36. IAS 1 permits a departure from IFRS if a particular IFRS would be so misleading that it would conflict with the objective of the financial statements set out in the Framework. FRS18, provides for a departure from UK accounting standards in similar circumstances. Both IAS 1 and FRS 18 require disclosure and justification.

37. Just as the legal underpinning of the requirement to attain the relevant benchmark differs as between companies Act accounts and IAS accounts so does that of the ability to depart from the relevant accounting standards. In the case of Companies Act individual accounts that ability is expressly stated in section 396(5) whereas section 397 requires IAS individual accounts[6] to have been prepared in accordance with international accounting standards[7]. IAS 1 was adopted by EC 1725/2003 and thus the ability to depart from an IFRS is incorporated by reference.

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[5] Formerly Paragraph 36A in Schedule 4 to the Companies Act 1985
[6] Section 406 for IAS group accounts
[7] Being those within the meaning of the IAS Regulation and adopted in accordance with it (section 474(1)).

38. Although both accounting frameworks recognise that a departure from an accounting standard may be necessary where compliance with that standard would produce a result so misleading that it would conflict with the objective of financial statements, the two frameworks use different terminology to describe the likelihood of such circumstances arising. IAS 1 states that the circumstances in which there should be such a conflict are "extremely rare". FRS 18 uses the word "exceptional".

39. Both these terms contemplate departures from a relevant standard in circumstances which are so removed from the contemplation of the relevant standard that compliance therewith would be inconsistent with the basic objective of fair presentation or true and fair view as the case may be. In my view, an English court dealing with words of such similar meaning as 'extremely rare' and 'exceptional' is most unlikely to discern any practical distinction between the circumstances which justify their use.

40. On any basis these words suggest that the circumstances in which departure from a relevant standard is appropriate are very limited indeed.

<u>Mechanical application of standards.</u>

41. Whilst the 1993 Opinion emphasised the central importance and authority of accounting standards in satisfaction of the requirement to give a true and fair view, it concluded that the true and fair requirement was the overarching concept to be used in the preparation of financial statements; a position which was emphasised by the express reference in the legislation of the true and fair override[8].

42 I am asked to consider whether there has been a subtle shift in the legal approach to fair presentation or indeed true and fair as a result of the statement in IAS 1 that the circumstances in which departure from a relevant international accounting standard could be justified are "extremely rare", coupled with the level of detail which is set out in the

[8] The phrase 'legislative override' is used to describe a legislative provision which provides that the requirement to achieve a true and fair view when preparing accounts take precedence over some other specific legislative provision relating to the preparation of accounts.

relevant standards, and the depth of expertise and consultation which is brought to bear in the standard setting process. Against this background, it may be said, that a preparer of financial statements in accordance with IAS can be certain that a fair presentation will always have been achieved if those standards are followed.

43. In my view a seeker after such certainty, whether in relation to IAS individual accounts or Companies Act individual accounts would be confusing outcome with process. In the case of IAS, any such suggestion is clearly contradicted by the fact that IAS 1 expressly provides for IFRS standards to be departed from and that the effect of the legislation is to require compliance with adopted IAS. In the case of individual accounts prepared under the Companies Act 2006, the same conclusion applies by virtue of section 396(5)..

44. It is no doubt true, as a practical matter, that, as accounting standards have become more detailed and departure from them has become harder to justify, the scope for persuading a Court that financial statements which do not comply with relevant accounting standards give a true and fair view, or achieve a fair presentation has become very limited and the scope for arguing that compliance with relevant accounting standards gives a true and fair view, or achieves a fair presentation, has correspondingly increased.

45. To make that observation, however, is only to comment on an historical trend which has been evident for some years and which, given the Court's approach to accounting standards as the surest guide to the attainment of the true and fair view, is unsurprising. It does not follow from that observation 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 judgment applied to ensure that those statements give a true and fair view, or achieve a fair presentation.

46. In my view, the true and fair, or fair presentation, concept, remains at the heart of the preparation of financial statements. It can aptly be described as an overarching

concept which should inform all decisions made by the preparers of such statements. My view derives from the following factors:

(A) The appropriateness of a particular standard may be undeniable, yet there may well be difficult questions of judgment in the application of that statement which affect, perhaps critically, the resultant quantification or appearance of items in the financial statements. Such judgment is not exercised in a vacuum but in order to give a true and fair view, or achieve a fair presentation.

(B) A departure from a relevant standard may be "extremely rare" or "exceptional", but the preparers of financial statements will always have to ask themselves whether departure is nonetheless required in their particular circumstances. No doubt, in very many cases that will be a very easy question to answer, but it must always be asked. Again the question is not asked in a vacuum; it is answered in order to achieve a true and fair view, or fair presentation.

(C) It is possible that the treatment of a particular item could be justified by reference to the application of two different, but equally relevant, standards. A choice will have to be made. Again the question is not asked in a vacuum and is answered in order to give a true and fair view, or achieve a fair presentation.

(D) It is also possible that an undeniably appropriate treatment of another different item colours the judgments and questions referred to above.

(E) The greater detail in standards and the greater depth and length of the standard setting process may give rise to severe timing difficulties in that economic and financial circumstances can change at great speed. The pace of innovation in financial instruments, in particular, is relentless. The cost of the increased weight of the authority of a standard is in the length of time they take to be settled, still less generally used. This may cause particular difficulties in areas of swift change since the precise circumstances may not be covered by a relevant standard, or the instrument may be so new that there may be no standard at all. The question of how to present these transactions, whether by deciding upon the closest analogy or otherwise, can only be answered by reference to the need to give a true and fair view or achieve a fair presentation.

(F) Compliance with accounting standards is not an end in itself, but it is the means to an end. Hence the recognition in statute, so far as Companies Act individual accounts and the recognition in IAS 1 so far as IAS individual accounts are concerned, of the true and fair, or fair presentation, override.

The Transparency Directive

47. The last piece of European legislation which has impacted upon companies and their accounts has been the Directive 2004/109/EC ("the Transparency Directive") which has introduced, in relation to the companies to which it applies (broadly listed companies whose securities are admitted to trading on a regulated market), a requirement to produce half yearly reports.

48. The Transparency Directive, in so far as it refers to a true and fair view, is an example of the content of that concept being moulded by the expectations of the users of financial statements. The first reference is in Recital 9, which is in these terms:

> *"[The IAS Regulation] has already paved the way for a convergence of financial reporting standards throughout the community for issuers whose securities are admitted to trading on a regulated market and who are required to submit consolidated accounts. Thus, a specific regime for security issuers beyond the general system for all companies, as laid down in the Company Law Directives, is already established. This Directive builds on this approach with regard to annual and interim financial reporting, including the principle of providing a true and fair view of an issuer's assets, liabilities, financial position and profits or losses. A condensed set of financial statements, as part of a half-yearly financial report, also represents a sufficient basis for giving such a true and fair view of the first six months of an issuer's financial year"*

49. Article 5(2) prescribes what the half-yearly financial report should consist of. It is in these terms:

> "2. *The half-yearly financial report shall comprise:*
>
> *(a) the condensed set of financial statements;*
>
> *(b) an interim management report;*
>
> (c) *statements made by the persons responsible within the issuer, ...to the effect that, to the best of their knowledge, the condensed set of financial statements which has been prepared in accordance with the applicable set of accounting standards gives a true and fair view of the assets, liabilities, financial position and profit and loss of the issuer, or the undertakings included in the consolidation as required under paragraph 3, and that the interim management report includes a fair review of the information required under paragraph 4."*

50. The requirement to confirm that the condensed financial statements give a true and fair view would, if the true and fair requirement were not an elastic concept moulded in part by the expectations of users, give rise to a conundrum; namely, how could a standard which must be applied to audited accounts for a full year be complied with in relation to half-yearly accounts which not only do not require an audit report, but also are self-evidently not meant to be as detailed as accounts for a full year?

51. As matter of principle the answer is supplied by remembering that any set of accounts is, of necessity, an exercise in distillation and summary so as to be generally and reasonably useful to their users. The extent of the summary is, in part, determined by the expectation of the users. In relation to interim financial statements, the user is likely to have or have had access to the full year accounts and, in the interests of timeliness, avoidance of repetition and cost, is likely to be looking for, in effect, an update and an appraisal of any new significant matters affecting the company. This is recognised by IAS 34 (Interim Financial Reporting) and ASB Statement "Half-yearly financial reports. Accordingly, one would expect that a set of half yearly accounts which complied with standards relevant to interim reporting to give a true and fair view, or achieve a fair

presentation.

52. And so it has proved. Part 43 of the Companies Act 2006 has implemented, as from 20th January 2006, the Transparency Directive by amending the Financial Services and Markets Act 2000. As the relevant authority, the Financial Services Authority has made Disclosure Rules and Transparency Rules which, by Rule 4.2.10, provide that the requirement to confirm that the condensed set of financial statements give a true and fair view will be satisfied by including a statement that the financial statements have been prepared in accordance with IAS 34, or, for UK issuers not using IFRS, pronouncements on interim reporting issued by the ASB and for all other issuers not using IFRS, a national standard relating to interim reporting.

53. Accordingly, in my view the European Directives and Regulations have not required any change in the approach articulated in the Opinions.

SECTIONS 393 AND 495 OF THE 2006 ACT

54. I have been asked to comment in particular on Sections 393 and 495. Section 393 provides as follows:

> *(1) 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.*
>
> *(2) The auditor of a company in carrying out his functions under this Act in relation to the company's annual accounts must have regard to the directors' duty under subsection (1)*

Section 495 sets out the obligation upon the auditors to prepare a report and the required content of that report. It provides, relevantly, as follows:

(2) The auditor's report must include-

(a) An introduction identifying the annual accounts that are the subject of the audit and the financial reporting framework that has been applied in their preparation, and

(b) A description of the scope of the audit identifying the auditing standards in accordance with which the audit was conducted.

(3) The report must state clearly whether, in the auditor's opinion, the annual accounts-

(a) give a true and fair view-

(i) in the case of an individual balance sheet, of the state of affairs of the company as at the end of the financial year,

(ii) in the case of an individual profit and loss account, of the profit and loss of the company for the financial year,

(iii) in the case of group accounts, of the state of affairs as at the end of the financial year and of the profit or loss for the financial year of the undertakings included in the consolidation as a whole, so far as concerns members of the company

(b) have been properly prepared in accordance with the relevant financial reporting framework; and

(c) have been prepared in accordance with the requirements of this Act (and, where applicable, Article 4 of the IAS Regulation).

55. Section 393 makes no distinction between Companies Act individual accounts, IAS individual accounts or group accounts. Curiously, it is phrased as a negative obligation; directors are not to approve accounts unless they are satisfied that they give a true and fair view. Section 393 was not originally in the Companies Bill. It was added in November 2005. The ministerial statement on its introduction was to the effect that the clear primacy of the true and fair concept had become blurred as a result of a combination of United Kingdom and Community law provisions and the opportunity was taken to express this principle more clearly in the legislation. The object of the inclusion of sub-

section (2) was to "*underline the point that directors and auditors should approach the accounts with the same common sense objective of ensuring that accounts give a true and fair view of the company's financial position.* The approach necessary to achieve this objective is discussed in paragraphs 23 to 29 above.

56. In the light of the fact that the stated reason forof the introduction of section 393(1), which applies to all types of accounts, was a desire to clarify an existing concept, which had perhaps become obscured by legislative changes, the inclusion of section 393 will not, in my view, be taken to have altered the central conclusion set out in the Opinions and affirmed by the Courts. At best, it provides support for the conclusion that there has been no shift of the type set out in paragraph 41 above to a more mechanistic approach to the preparation of financial statements.

57. For the same reasons, the provisions of section 495 do not in my view require any change to the approach as articulated in the Opinions. Again, if anything the separation in sub-section (3) of the three matters which must be stated clearly in the auditor's report serves to emphasise the different elements required. In that respect the section is of a piece with Section 393 and points to Parliament's intention to maintain the primacy of the true and fair requirement as the overarching concept in the preparation of financial statements. It is not to be taken as undermining the approach to the attainment of that standard as described in the Opinions.

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21st April 2008

Appendix

Tomberger v. Gebruder von der Wettern

1. In *Tomberger v. Gebruder von der Wettern* Case C -234/94 [1996] 2 BCLC 457 the facts were that two wholly-owned subsidiaries of a holding company adopted accounts for the year to 31st December 1989 on 26th June 1990 which showed profits appropriated to the holding company. At the general meetings of the subsidiaries decisions were taken to distribute the profits to their shareholders, namely the holding company. The accounts for the holding company were also drawn to 31st December 1989, but were both audited and adopted by its shareholders after 26th June 1990. The holding company's accounts did not show the subsidiaries' profits as profits of the holding company. A shareholder commenced proceedings on the basis that such profits should have been shown in the holding company's accounts to 31st December 1989. The national court considered that the treatment contended for by the shareholder was compulsory, but referred the matter to the ECJ for a ruling on compatibility.

2. The relevant Article of the Fourth Directive was Article 31(1)(c) & (d) which provides as follows:

> *"(c) valuation must be made on a prudent basis, and in particular:*
>
> *i. (aa) only profits made at the balance sheet date may be included,*
>
> *ii. (bb) account must be taken of all foreseeable liabilities and potential ;losses arising in the course of the financial year concerned or of a previous one, even if such liabilities or losses become apparent only between the date of the balance sheet and the date on which it is drawn up,*
>
> *iii. (cc) ....*
>
> *(d) account must be taken of income and charges relating to the financial year, irrespective of the date of receipt or payment of such income or charges,"*

3. In his Opinion, the Advocate General referred to these provisions as incorporating the prudence concept and accruals concept. Tellingly, he went on to describe them in these terms:

> *"Both of these principles constitute a cogent enunciation of the more general principle of a true and fair view' (quadro fedele[9]), the actual guiding criterion of the Community rules as a whole, laid down in art 2 of the directive. That principle requires the balance sheet to be drawn up so as to give not only a true (even in the relative sense in which that adjective is traditionally and necessarily used as regards balance sheets) but also a fair (essentially with regard to the good faith of the persons drawing up the balance sheet) representation of the company's assets and liabilities, its financial position and its profit or loss"*

4. In his Opinion, the Advocate General noted that the German and United Kingdom governments ascribed importance to the sole control by the parent company and their argument that an approach which did not allow contemporaneous entry of profits in those circumstances would be excessively restrictive and formalistic. As a result, the Governments contended that the parent company's right to a profit came into existence in financial terms, even if it had not been specified in legal terms.

5. However, the Advocate General took the view that the German rules were not compatible, essentially because the holding company could not be said to have made a profit as at 31st December 1989 when it had no legal entitlement to receive a dividend until the appropriation after the year end. The Advocate General did not accept that there was a wide discretion in defining "profits made" in art 31 (c)(aa). He relied on the fact that the article required member states to ensure that the items shown in the annual accounts are valued in according to the general principles there set out. He also went on to say:

"[9] In the French version, "image fidele"; in the German: den tatsachlichen Verhaltnissen entesprechendes Bild". I would note that the expression "rappresentazione veritiera e correcta" was preferred to "quadro fedele" when the Italian Civil Code was amended in order to implement the fourth directive (see art 2423 of the Italian Civil Code"

> *"Secondly, the directive, as I have already pointed out, does not merely require prudence in general terms but also takes care to define its substance with various detailed provisions which implement it, including the possibility of including in the balance sheet only profits actually made at the end of the financial year. In those circumstances, it seems to me that the rationale on which the provision is based would be undermined if it were possible to interpret it in a way suggested by the German government".*

6. Furthermore, he considered that that whatever may be the position as to the interpretation of the phrase "profits made", it could not encompass a purely future profit.

7. The provisions of the Advocate General's opinion are important because of the discussion of the true and fair requirement in the Directive, and because the ECJ declined to follow his recommendation, which on purely linguistic grounds had considerable merit.

8. The ECJ's judgment affirmed the true and fair requirement as the primary object of the Fourth Directive, and adopted an approach to interpretation of the detailed provisions of the Fourth Directive which ensures the achievement of that objective. To put it in other words, it considered a purely literal or linguistic approach to construction of the relevant provisions was not appropriate. The ECJ disposed of the case in these terms:

> *"17. Article 31 of the fourth directive seeks to coordinate national provisions concerning the presentation of annual accounts of certain types of companies (see the first recital of the preamble). In order to coordinate the content of annual accounts, the directive lays down the principle of the "true and fair view", compliance with which is the primary objective of the directive. According to that principle, the annual accounts of companies to which the fourth directive applies must give a true and fair view of their assets and liabilities, financial position and profit and loss (see fourth recital in the preamble to the fourth directive and art 2(3) and (5) thereof).*
>
> *18. Application of that principle must, so far as possible, be guided by the general principles contained in art 31 of the fourth directive. In this*

case, the principles set out in art 31(1)(c)(aa) and (bb) and (d) are of particular importance.

19. First, art 31(1)(c)(aa) provides that only profits made at the balance sheet date may be included in the balance sheet.

20. Second, art 31(1)(d) provides that account must be taken in the balance sheet for a financial year of all income and charges relating to that year, irrespective of the date of receipt or payment of such income or charges.

21. Third, in accordance with art 31(1)(c)(bb), account must be taken of liabilities and losses arising in the course of a financial year even if they become apparent only between the end of the financial year and the date on which the balance sheet for that year is drawn up.

22. It is clear from those provisions that taking account of all elements – profits made, charges, income, liabilities and losses – which actually relate to the financial year in question ensures observance of the requirement of a true and fair view.

23. *In the present case, according to the subsidiary's annual accounts, the profits in question were made by that company during the financial year 1989 and were appropriated by it to the parent as at 31 December 1989, that is to say before the financial year. Before examining the parent company's accounts, the national court must be satisfied that there is no reason to question that that presentation of the subsidiary's financial position complies with the principle of the true and fair view.*

24. *It follows from all the foregoing that, if the subsidiaries accounts themselves comply with the principle of the true and fair view, it is not contrary to the rule laid down in art 31(1)(c)(aa) of the fourth directive for the national court to consider that, in the circumstances described, the profits in question must be entered in the parent company's balance sheet for the financial year in respect of which the subsidiary appropriated them."*

9. The *Tomberger* case is important not only because it signifies a rejection by the ECJ of a formalistic or restrictive interpretation of the Directive in considering questions of compatibility, but also because of the insight it gives, in the Advocate General's opinion, of the meaning of true and fair. Thus, it seems that English law approaches "true and fair" as a blended concept, whereas the approach of Community law may be to regard it as a bifurcated concept, namely "true" and "fair".

10. This seems to me to be a distinction without a difference, in that both approaches are attempting to ascribe meaning to the same concept. This follows from the acceptance of the Advocate General that the adjective "true" is necessarily used in a relative sense and his references to "good faith". As a translation of "fidele" or "fedele" it might have been better rendered in English as "faithful" which is not the same thing as "good faith" so far as that term might be understood by an English lawyer.

<u>ES Bauunternehmung GmbH v Finanzamt Bergeheim</u>

11. The approach of the ECJ to the true and fair requirement in *Tomberger* was reiterated by the ECJ in the case of *DE + ES Bauunternehmung GmbH v Finanzamt Bergeheim* Case C- 275/97 [2000] BCC 757. The ECJ again construed the detailed provisions of the Directive against the yardstick of the true and fair requirement and, furthermore, subjected an exceptional case departure to a true and fair requirement.

12. The case involved a German building company which sub-contracted some building works and made a global provision to cover the costs of remedying any defects in such work which were covered by warranties given by it. It did not specifically identify each claim because it could not identify whether such claims would require it to carry out repair work for no charge, to replace items, re-do certain works, reduce prices paid or pay damages. Instead it made a global provision calculated as percentage of annual turnover.

13. The articles in point were Arts 20(1) and 31(1)(e) which provide respectively as follows:

> *"20(1) – provisions are intended to cover losses or debts the nature of which is clearly defined and which at the date of the balance sheet are either likely to be incurred, or certain to be incurred but uncertain as to amount or as to the date on which they will arise*

> *31(1)(e) – the components of asset and liability items are to be valued separately"*

14. The ECJ accepted the argument of the German government that, even if only some of these liabilities materialised, these liabilities were inescapable even if it was not possible to say whether and to what extent the company would be obliged to bear them or to quantify them precisely. It held that any alternative interpretation of Art 20(1) would mean that such potential debts did not appear in the balance sheet and would be contrary to the principle of a true and fair view, compliance with which was the primary objective of the Directive.

15. In relation to the requirement that liability items should be separately valued, the ECJ invoked the true and fair override provided for in Art 2(5). A requirement which it described in the following terms:

> *"27. The principle of a true and fair view requires that the accounts reflect the activities and transactions which they are supposed to describe and that the accounting information be given in the form judged to be the soundest and most appropriate for satisfying third parties' needs for information, without harming the interests of the company"*

16. In a rather opaque passage the ECJ referred to the exceptional case exception in Art 31(2) in this way:

> *"31. Since the directive does not define what is meant by "exceptional cases", this expression must be interpreted in the light of the directive's aim, which, as indicated ....above, is that the annual accounts of the companies concerned must give a true and fair view of their assets, of their financial position and of their profit or loss.*
>
> *32 The exceptional cases referred to in art 31(2) are therefore those in which separate valuation would not give the truest and fairest possible view of the actual financial position of the company concerned"*

17. The reference to "truest and fairest" is puzzling, since it suggests that there is a hierarchy of true and fair, which gives rise to the difficulty that even the lowest place in

the hierarchy would be a true and fair view and therefore have attained the necessary standard to comply with the requirement in the Directive. In my view, the ECJ was not seeking to suggest that there is such a hierarchy where compatibility requires achieving the top level, but rather to indicate that what might have been a true and fair view in one situation is not necessarily true and fair in another.