9 August 2005

THE IMPLICATIONS OF NEW ACCOUNTING AND AUDITING STANDARDS FOR THE "TRUE AND FAIR VIEW" AND AUDITORS' RESPONSIBILITIES

Introduction

The Financial Reporting Council (FRC) believes that the new framework of accounting and auditing standards provides a basis for confidence in financial reporting and corporate governance that is at least as strong as has been in place in the UK during the last twenty years. In particular, true and fair remains a cornerstone of financial reporting and auditing in the UK and professional judgement will continue to be central to the preparation and audit of financial statements.

The Financial Reporting Council (FRC) is the UK's independent regulator for corporate reporting and corporate governance. Through several of its operating bodies (the Auditing Practices Board, the Professional Oversight Board for Accountancy and the Accountancy Investigation and Discipline Board) the FRC has primary responsibility for setting, monitoring and enforcement of auditing standards in the UK. A further operating body, the Accounting Standards Board, sets UK accounting standards. Another operating body, the Financial Reporting Review Panel, has primary responsibility for monitoring and enforcing compliance with accounting requirements in the UK.

Significant changes in financial reporting in the UK have taken place from 2005 as a result of the EU requirement for listed companies to adopt international accounting standards (IAS). Furthermore, the standards that auditors in the UK have to follow have also changed following the introduction in the UK of new standards based on International Standards on Auditing (ISAs). Those changes will potentially affect preparers, auditors and users of financial statements.

The move to IAS will result in changes in key measures such as profit and net assets, the format of financial statements, and the terminology used in the statements. One change in terminology that has received particular prominence is the replacement of "true and fair" by "fair presentation" as the over-arching test that financial statements should satisfy.

Some commentators have expressed concerns that these changes have resulted in a weakening of the safeguards against corporate scandals. There have been suggestions that the "true and fair view" concept is in jeopardy and that the new auditing standards require a "tick box" approach. The FRC believes that these concerns are misplaced.

Interpreting the new framework

The new framework for financial reporting and auditing consists of a number of components, including EU Directives, EU Regulations, UK company law, standards issued by standard-setters following consultation and legal opinions. Ultimately, in cases of dispute, whether a company has met its financial reporting obligations or whether an auditor has discharged his responsibilities are matters for the Courts to decide. Those matters may require determination by the European Courts since the reporting and auditing obligations in the UK are largely based on European Directives and Regulations. As a result, many years may elapse before the Courts can provide legal certainty (if ever). Consequently, it will not be possible for those companies and their auditors who need to make decisions this year on financial reporting questions to rely upon Court decisions for guidance. Nor would that be a practical proposition for users of financial statements.

Against this background, the FRC has concluded that it would be helpful for preparers, auditors and users of financial statements for it to publish a statement setting out its understanding of the impact of the new framework of accounting and auditing standards on the true and fair view.

The attached paper considers the principal components of the new framework and sets out the FRC's understanding of the impact of that framework on financial reporting and auditing.

The FRC has concluded that, although the introduction of "presents fairly" into the accounting framework by the adoption of IAS and ISAs (UK and Ireland) will result in changes to the format and content of both company accounts and audit reports:

- the concept of the "true and fair view" remains a cornerstone of financial reporting and auditing in the UK;
- there has been no substantive change in the objectives of an audit and the nature of auditors' responsibilities; and
- the need for professional judgement remains central to the work of preparers of accounts and auditors in the UK.

Given the importance of these matters and their significance to the future work of the FRC and its operating bodies, and as good regulatory practice, it is appropriate for the FRC to publish in the attached paper its understanding and conclusions and to welcome comment by interested parties.

Those respondents to this paper who have conclusions that differ from those set out in the attached paper will be more likely to influence the FRC's future thinking if they set out in detail the basis for their views.

Potential future development of the framework

The primary focus of this paper is the framework of financial reporting and auditing that is now in force, based on existing law and standards. We do, however, fully recognise that the framework has the potential to evolve further in the future. The FRC expects to play an important part in the debate on the future evolution of that framework.

The FRC would welcome views on how financial reporting and auditing should evolve in future. It would be very helpful if respondents to this paper could clearly distinguish any views that they may wish to express about the future framework from their views on the proper interpretation of the current framework.

The closing date for responses is 1st November 2005. Views on the future development of the framework will be taken into account in the development of the FRC's Plan & Budget for 2006/07 which is expected to be published in January 2006.

Responses to this paper should be sent by e-mail to framework.paper@frc.org.uk or in writing to:

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This paper sets out the reasons for the FRC's views.

The impact of International Accounting Standards on company accounts

The decision by the European Union to make it a legal requirement for companies whose securities are traded on a regulated market of any member state to prepare their consolidated accounts in accordance with International Accounting Standards (IAS) as adopted by the EU is having a major impact on financial reporting in the UK.

"True and fair" and "presents fairly"

Companies that prepare accounts under IAS must change the terminology used to describe the objective of their annual accounts. The obligation under IAS is to prepare financial statements that "present fairly" a company's financial position, financial performance and cash flows (IAS 1 'Presentation of financial statements', paragraph 13).

To reflect this change, the UK Companies Act has been amended (SI 2004/2947) so that companies who report under IAS are no longer required to prepare accounts which give a "true and fair view". Instead, where directors prepare financial statements in accordance with IAS, and hence in accordance with the "fair presentation" requirement, they must include a note in the financial statements that those financial statements have been prepared in accordance with IAS (as adopted by the EU).

Concerns have been expressed that this change weakens the safeguard provided by the requirement for accounts to show a true and fair view that has been a cornerstone of financial reporting in the UK for many years. The FRC believes that this concern is misplaced for the following reasons:

1. The IASB's Framework for the Preparation and Presentation of Financial Statements states that the application of the principal qualitative characteristics of financial statements, as set out in the Framework, and the application of appropriate accounting standards normally results in financial statements that convey what is generally understood as a true and fair view of, or as presenting fairly such information.

2. It is a requirement of the EU's International Accounting Standards Regulation that only IAS that are consistent with the basic requirement to give a "true and fair view" may be adopted for use in the EU.

3. IAS expressly recognise that their detailed requirements are not exhaustive. IAS 1, paragraph 15, requires entities "to provide additional disclosures when compliance with the specific requirements in the IFRS is insufficient to enable users to understand…the entity's financial position and performance."; thus retaining a key feature of the Companies Act 1985.

In these circumstances, the FRC believes that the intent and substance of the two expressions – 'presents fairly' and 'true and fair' - are similar.

The FRC recognises that financial statements prepared under the IAS framework will look different from accounts prepared under the UK requirements, and key measures such as net profit and net assets will be different. However, such differences will be due to the varying requirements of the accounting standards; they will not be attributable to any fundamental distinction between the expressions "true and fair" and "present fairly". Furthermore, some of the changes in key measures such as net profit and net assets would have occurred in the UK even if the move to IAS had not taken place. For example, IAS requires that the fair value of share options issued to employees be treated as an employment cost; this accounting treatment is also required by a new UK accounting standard. There are many similar examples.

Departures from accounting standards

The position in relation to departures from accounting standards is substantively the same under the existing UK framework and IAS. Under both frameworks

1. companies must depart from particular requirements of accounting standards if compliance is inconsistent with the requirement to give a true and fair view or fair presentation.

2. where companies are required to depart from a requirement, they must make similar disclosures including the nature of the departure, the reasons for it and the financial impact.

3. departures are expected to be rare. Under the UK framework, departures from accounting standards, which are contemplated by FRS 18 (paragraphs 15 and 16), are justifiable only "in exceptional circumstances". Under IAS, departures are expected to be "in extremely rare circumstances".

It has been said that the use of the 'true and fair override' (a phrase that encompasses departures both from accounting standards and from a detailed accounting requirement of the Companies Act) will diminish as a result of the requirement to comply with IAS and that, as a result, companies' accounts will not show a true and fair view. That is to misunderstand the circumstances in which the true and fair override has been used in recent years in the UK. An analysis of the use of the "true and fair over-ride" by Company Reporting Limited shows that in 96% of cases where the override was used, the override has been invoked to justify departures from provisions of the Companies Act in order to *comply* with accounting standards - a common example being where investment property companies depart from the statutory requirement to depreciate their properties so as to comply with Statement of Standard Accounting Practice 19 which requires the properties to be

shown on the balance sheet at market value.[1] In the remaining 4% of those cases, the override was used to *depart* from accounting standards; which illustrates the importance that accounting standards now play in ensuring that financial statements give a true and fair view.

'True and fair' in the context of International Accounting Standards

Attention has also focussed on the fact that, under IAS, 'presents fairly' is construed together with the phrase '*in accordance with international financial reporting standards'.* Although the requirement for a 'true and fair view' makes no reference to accounting standards, in practice and effect, the legal requirement in the UK has, for many years, been to prepare accounts which give a true and fair view *in accordance with UK accounting standards.*

This was confirmed by Mary Arden QC in her 1993 opinion, reinforcing her 1983 and 1984 joint Opinions with Leonard Hoffmann QC, when she advised that whether accounts satisfy the true and fair requirement is a question of law, but that in considering that question a Court would have regard to evidence in the form of the established practices and views of accountants and which are, to a large extent, represented in the form of 'accounting standards'.

The FRC believes that, in circumstances where there is more than one framework in use (IAS and the existing UK framework), the inclusion of references to the financial reporting standards used is intended to identify the framework in accordance with which the financial statements have been prepared and is not intended to constrain the preparation or audit of those financial statements.

The impact of International Accounting Standards on the "true and fair" audit opinion

The decision by the European Union to require listed companies to adopt IAS in their consolidated accounts also has implications for auditors. However, this decision does not change the nature of auditors' responsibilities.

The UK Companies Acts have long required auditors to give an opinion as to whether the accounts of a company gave a true and fair view. Similarly, since 1978, the 4th European Company Law Directive has required auditors to express a "true and fair" opinion.

[1] The Companies Act has recently been amended to permit the accounting treatment adopted by SSAP 19.

The introduction of the IAS framework means that some companies in the EU will prepare their accounts under that framework whilst others will prepare their accounts under the previous framework. In order to avoid confusion between the two frameworks, the 4th Directive and, subsequently, the Companies Act have now been amended to require the auditors to state "in particular whether the annual accounts give a true and fair view *in accordance with the relevant financial reporting framework*" (italics added). Guidance issued by both the EU and the DTI has made it clear that this language is not intended to constrain the preparation or audit of those financial statements – the later has stated that the inclusion of this information "does not represent a restriction of scope of that opinion but clarifies the context in which it is expressed".

While legislation now requires the auditors to refer expressly in their reports to the accounting framework which has been applied, the essential requirement for auditors to give a "true and fair" opinion on the accounts has not been changed.

The impact of the UK's new Auditing Standards

New auditing standards came into effect in the UK for accounting periods commencing on or after 15 December 2004. These standards were adopted by the Auditing Practices Board (APB) after a period of public consultation and analysis which commenced in September 2002 with the publication of a consultation paper 'Priorities and future work programme'. In that paper the APB explained the background to, and rationale for, the introduction of these new standards.

The government's review of arrangements for UK audit and accounting following the collapse of Enron (the Consultative Group on Accounting and Auditing) supported the move towards International Standards on Auditing (ISAs) and welcomed APB's commitment to work with the International Auditing and Assurance Standards Board (IAASB) to improve auditing standards on an international basis provided that this would not lead to a dilution of UK standards.

APB decided to base its new standards on ISAs because it:

- supports the international harmonisation of auditing standards. Most listed companies have overseas operations. It is important to users of financial statements, including investors, that audits of overseas subsidiaries of UK entities are audited to the same high quality standard as domestic activities;
- wished to take advantage of the work undertaken by IAASB in ensuring that recent revisions to ISAs on audit risk, fraud and quality control reflect the most advanced thinking; and
- wishes to take advantage of the developments that can be expected from the update of other ISAs as a result of IAASB's ongoing revisions programme.

In 2004 APB undertook a rigorous comparison of the existing UK auditing standards (SASs) to the equivalent ISAs to identify instances where the SASs contained higher standards (recognising that IAASB had not completed the revision of all ISAs). APB also identified guidance in the SASs for which there was no equivalent in the ISAs, and which APB believed continued to be both relevant and helpful. As a result APB concluded that it was necessary to incorporate some material from the SASs into the ISAs to maintain the quality of UK and Irish standards and also to address specific national legal and regulatory requirements. The additional material introduced by APB is clearly differentiated from the original text of the ISAs by the use of grey shading.

The new standards are known as "International Standards on Auditing (UK and Ireland)" to reflect the fact that they are based on the IAASB's standards but have additional requirements necessary to meet UK requirements.

While in some areas the new standards are more demanding[2] than the previous standards they are not radically different. Both sets of standards require compliance with 'basic principles and essential procedures' and the introduction of ISAs (UK and Ireland) has not resulted in a significant increase in such requirements.

In particular, the new standards have not changed:

- the fundamental purpose of the audit (which is to express a "true and fair" opinion); this fundamental purpose is a requirement of the Companies Act and cannot be amended by an auditing standard;
- the importance of the auditors' professional judgement in determining the procedures to be undertaken and the opinion to be expressed; and
- the fact that compliance with the specific procedural requirements of the standards will not necessarily be sufficient for the auditor to have a proper basis for his opinion.

The potential impact of the EU's new 8th Company Law Directive

A revised version of the 8th Company Law Directive, which deals with the audit of annual and consolidated accounts, has been under negotiation in the EU for some time and is believed to be close to final agreement.

One potential effect of the Directive is to introduce the possibility that ISAs will be adopted for use across the EU at some later date. However, whether and when this might happen is not certain. The uncertainties include:

[2] Audit Risk and Fraud are particular areas where auditors are required to undertake additional procedures following the introduction of the new ISAs (UK and Ireland).

- unlike the case of International Accounting Standards, no target date for adoption has been set; and
- whether the Commission will be able to satisfy itself that the ISAs:
  - are generally accepted internationally and are developed with proper due process, public oversight and transparency;
  - contribute to a high level of credibility to the annual and consolidated accounts; and
  - are conducive to the European public good.

If some or all of the ISAs are not adopted by the EU then member states will retain the freedom to specify the standards which they believe to be appropriate.

The APB has devoted considerable resources to influencing the development of ISAs with the goal of ensuring that they reflect the public interest and that the likely increase in the number of specific procedural requirements on auditors does not undermine the application of professional judgement. It believes that these efforts have been successful to date and it expects to continue these efforts in the future.

The FRC also intends to play a leading role in the process of review and adoption of ISAs by the EU with the intention of ensuring that the standards adopted are consistent with existing UK views on the nature of the auditor's responsibilities.

The relationship between auditors and shareholders

Some commentators have argued that that auditors have a responsibility to identify and report to shareholders situations in which management have acted contrary to the interests of shareholders.

Any interpretation that imposes a duty that goes beyond an auditor's duty to express an opinion on the financial statements of a company would, the FRC believes, go well beyond what Parliament intended. If there was a general duty on auditors to report on matters unrelated to the financial statements where management had not acted in the interests of shareholders then auditors would be required to express views on matters which were outwith their competence.

The FRC does, however, recognise that the nature of relationship and degree of communication between auditors and those primarily responsible for safeguarding the interests of shareholders - namely non-executive directors and others responsible for the governance of organisations – are vital components of audit quality.

In that context it is to be noted that, in 2001, the APB extended the then existing UK auditing standards to establish new requirements in relation to the wider range of important communications of matters arising from the audit of financial statements that the auditors believe to be both important and relevant to those charged with governance in overseeing the financial reporting process. Such matters included relationships that may bear on the auditors' independence and objectivity; audit planning information; and the findings from the audit, including the auditors' views on the qualitative aspects of the entity's accounting and reporting. UK standards in this regard are more rigorous that the current ISAs and supplementary requirements and guidance have been included in ISA (UK and Ireland) 260 'Communication of Audit Matters with those charged with governance' to maintain the UK requirements. The APB is encouraged by that fact that in March 2005, IAASB issued an exposure draft of revisions to ISA 260 which substantially reflects the APB standards.

The FRC is committed to developing a clearer understanding among stakeholders on the range of factors impinging on audit quality, including auditing and ethical standards and identifying priority areas for improvement. This process must build on the ongoing work of the FRC's operating bodies. And it must benefit from the range of work being done in external organisations, including the valuable work being done under the auspices of the Audit Quality Forum. The Government and the FRC believe it is right that there should be an open and constructive dialogue among stakeholders on these important issues.

Other recent developments related to audit quality

An important aspect of the strengthening of the UK regulatory regime introduced in April 2004 was the introduction of monitoring of the quality of audits of major public interest entities independent of the professional accountancy bodies. In its first year of operation POBA's audit inspection unit focussed on the Big Four firms of auditors and their audits of the largest 350 publicly listed companies in the UK. The audit inspection unit does not focus solely on compliance with the requirements of the existing UK regulatory framework but adopts a more holistic approach to audit quality. An important aspect of its work is evaluating the appropriateness of the key audit judgements exercised in forming the audit opinion and challenging those judgements where appropriate. The FRC regards the critical independent assessment of those judgements as an essential safeguard to audit quality.

The FRC's conclusions

The FRC has concluded that, although the introduction of "presents fairly" into accounting standards and other recent changes to accounting and auditing standards will result in changes to the format and content of both company accounts and audit reports:

- the concept of the "true and fair view" remains a cornerstone of financial reporting and auditing in the UK;
- there has no been substantial change in the objectives of an audit and the nature of auditors' responsibilities; and
- the need for professional judgement remains central to the work of preparers of accounts and auditors in the UK.