

“Law and Regulation Working Paper” 20 April 2012: Comments from USS, Railpen and RLAM

27 April 2012

There are two important errors in the UK Competition Commission’s Working Paper on Law and Regulation (April 2012) that need to be urgently addressed. The first relates to the definition of what is meant by a “true and fair view”. The second relates to auditor liabilities and responsibilities to shareholders.

True and Fair view (para 3.50-3.53)

The document states that there is no statutory definition of the phrase “true and fair view”, and also no case law which provides guidance. It goes on to conclude in para 3.53: “*It therefore appears in practice that the phrase equates to being computed in accordance with the relevant accounting principles*”. We strongly disagree with this assessment, as outlined below.

Statutory definition

2006 Companies Act (Part 15) clearly sets out the legal duty of directors to ensure accounts provide a “true and fair view”. This underpins requirements in Part 23 that directors ensure solvency (net assets are greater than zero) and that no distributions are made out of capital. In other words a key function of the “true and fair” requirement is to permit directors to discharge their duties to the company. Penalties apply where directors fail in this duty.

These requirements are also present in the Fourth European Directive (78/660/EEC).

Moreover it is clearly stated in Part 2, Section A (“Accounting Principles”), para 13 of the 2008 Regulations on Reports and Accounts states that all amounts must be determined on a “prudent basis”.

Case Law

The Case of BDDL in 2003 is clear:

“The liquidators pointed out that a dividend could only be declared out of realisable profits, that there had been no general meeting to approve the dividend and that BCCL’s financial statements for the year to 31 July 2003 did not represent a true and fair view of the company’s financial position. The High Court held that the valuation of stock in BCCL’s accounts did not represent its realisable value and that the financial statements did not represent a true and fair view of the company’s financial position and found that the Final dividend was unlawful. The High Court also found that the Interim dividend was unlawful as it was not able to pay its debts as they fell due at the time of payment of the dividend.”¹

¹ See <http://www.brethertons.co.uk/Home/News-and-Events/Newsletters/InsolvencyBulletin/Insolvency-Bulletin-August-2011.aspx>

In addition, there is case law in Europe, which also adopted the “true and fair” requirement in their 2nd, 4th and 7th Directives. There are two cases from the European Court of Justice (attached) that are clear:

1. Tomberger v G von der Wettern GmbH Case C-234/94 (1996) 2 BCLC 457, and
2. DE + ES Bauunternehmung v F Bergheim Case C-275/97 (2000) BCC 757

It is not enough to conform to accounting standards

In 2008, the FRC received an updated opinion from Martin Moore QC (attached) which sets out clearly that the “true and fair” requirement is an over-arching concept, and is not the same as compliance with accounting standards. In other words, even where a company complies with an accounting standard, if the accounts fail to provide a “true and fair” view, then they are inadequate. Indeed, Moore points to the fact that accounting standards (whether domestic or international) allow for departure from their rules to allow accounts to comply with the true and fair requirement.

“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” (para 4(G), Moore QC, 2008)

The Hoffman opinion (quoted in para 3.51) holds so long as the ASB sets standards in accordance with the Companies Act, and they provide a true and fair view. The paper suggests the reverse logic: that compliance with the rules will deliver a true and fair view. The legal requirement – and objective standard - is the true and fair view, which allows directors to discharge their duties outlined in Company Law, i.e. no distributions out of capital and going concern / solvency.

The same is true at a European level, as made clear by the two cases noted above. The IAS Regulation (Regulation 1606/2002) is clear that an IAS should not occur where it would be contrary to the “true and fair” requirements of the 4th and 7th Directives.

The liabilities of the auditor – para 3.45-3.49

The paper concludes that “no duty is owed directly to the individual shareholders”, since this duty is protected by the duty to the company.

However, Part 11 of 2006 Company Act highlights the possibility of derivative action by shareholders where the company directors refuse to act on shareholders’ behalf (which is quite likely where action would result in them effectively suing themselves). In this case, shareholders can apply to the Court to force the company to act against the Directors, or the auditors. Please see attached brief on this from Freshfields (Sept 2007).