Local Authority Pension Fund Forum

The European Financial Reporting Advisory Group
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24th June 2015

Dear Sirs

EFRAG – call for comments on draft endorsement advice on IFRS 9

The Local Authority Pension Fund Forum was set up in 1991 and is a voluntary association of 65 local authority pension funds based in the UK with combined assets of approximately £165 billion. It exists to promote the investment interests of local authority pension funds, and to maximise their influence as shareholders to promote high standards of corporate governance and corporate responsibility amongst the companies in which they invest.

LAPFF is pleased to comment on the draft endorsement advice. The points LAPFF makes are significantly questioning of the endorsement process to the extent LAPFF believes the process has been fundamentally flawed. LAPFF would be happy to meet, or conference call, at the earliest opportunity.

Lack of proper process - the meaning of true and fair view

1. LAPFF believes that EFRAG has been lacking objective and transparent legal criteria for assessing the true and fair view principle of the law for IFRS endorsement, and as a result has not been following the correct model of true and fair view in endorsing IFRS.

2. We note that the staff paper of the European Commission on the impact of the IAS Regulation in the EU dated 18th June 2015 recommends that there should be a common understanding as to what **true and fair view means** for the endorsement of IFRS. LAPFF agrees with that recommendation, particularly as EFRAG has not had clear criteria in producing its draft endorsement advice for IFRS 9, or indeed in issuing prior endorsement advice for other IFRS.

3. Fundamentally, we believe that the problem is that members of EFRAG may have been trying to interpret the words “true and fair view” in isolation, as distinct from referencing the law.

4. Given that the matter of whether accounts give a true and fair view can only be settled by a court of law, we question why EFRAG has not made reference to cases in the European Court of Justice on the matter of true and fair view. Relating to that we also question why EFRAG has not considered the purpose of true and fair view accounts as set

out in the Directives (as opposed to the purpose of accounts in the (unendorsed) IFRS Framework) for which remedies are sought in law through the courts[1]. The IAS Regulation explicitly requires endorsing IFRS for suitability against the true and fair view principle of the 4th Directive and the 7th Directives, and not some ad hoc version of true and fair view produced by accountants outside of the framework of the law.

5. In short, EFRAG seems to overlook that the IAS Regulation retains the paramount position of the true and fair view requirement for accounts of the 4th and 7th Directives and does not depart from it. The IAS Regulation does set other endorsement criteria, but that is as well as, and not a departure from the true and fair view requirement of the Directives.

Lack of proper process – the scope of endorsement advice, Company only accounts

6. We also believe that EFRAG has wrongly decided that it is deciding the suitability of IFRS in the EU for the compulsory use for the consolidated accounts of listed companies (Article 4 of the IAS Regulation), but not company only accounts (Article 5 of the IAS Regulation).

7. However, that is not what the IAS Regulation states. The IAS Regulation is clear that the endorsement of IAS applies to the suitability of IAS for the EU[2]. As this point is very important we have extracted the endorsement criteria from the IAS Regulation as footnote 1. There are three “ands” in the criteria. There is no separate endorsement process in the IAS Regulation ring-fencing the endorsement of Article 4 use from the endorsement of Article 5 use. Member states can decide whether to use IFRS, but that is not an endorsement decision, that is a choice based on something that EU endorsement should have decided the suitability of.

True and fair view and a governance function

8. True and fair view is the legal standard required of accounts under Company Law irrespective of codification of accounting methods (see Hoffman QC and Arden QC for the Accounting Standards Board 1983[3]).

9. Having originally come from UK law, the true and fair view requirement of accounts and the functional purpose of true and fair view company only accounts is codified in EU law in the 4th and 2nd Directives[4]. The purpose of true and fair view accounts as a standard to discharge **basic** director duties under company law, includes not making unlawful distributions (i.e. profits are correctly stated in the accounts) and not trading whilst insolvent (i.e. net assets exist to provide collateral for creditors). This purpose can be seen in paragraphs 5 and 6 of the Recital to the 4th and Recital 3 of the 2013 Accounting Directive.

10. Both UK and EU case law regard true and fair view as the question to be settled to determine whether a distribution is lawful (see Broadside Colours and Chemicals Ltd [2011] EWHC 1034 (Ch), and also see ECJ Case C-234/94 Tomberger 1999).

11. This governance function of true and fair view can also be seen, for example in the 1947 Companies Act, and the Irish Companies Act 1990[5] where true and fair view is not only

[1] The Recital to 4th Directive is clear that annual accounts are needed for creditor and member protection purposes. This is reflected in the decision of the ECJ in “GIMLE” 2013 (see para 12 of this letter).

[2] 1. *In accordance with the procedure laid down in Article 6(2), the Commission shall decide on the applicability within the Community of international accounting standards.*
2. The international accounting standards can only be adopted if:
— they are not contrary to the principle set out in Article 2(3) of Directive 78/660/EEC and in Article 16(3) of Directive 83/349/EEC and are conducive to the European public good and,
— they meet the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

[3] Para 3 of that Opinion.

[4] For the equivalence of UK and EU law, having come from UK law see Lady Justice Arden **"**It's A Wrap (UK) Ltd v Gula & Another [2006] EWCA Civ 544 ”.

[5] *Section 202 (4) “For the purposes of subsections (1), (2) and (3), proper books of account shall be deemed to be kept if they comply with those subsections and give a true and fair view of the state of affairs of the company and explain its transactions”.*

the standard for the annual accounts, it is also the basic standard for the books of account at all times for the directors.

12. If true and fair view ("TFV") requirement does not mean something to discharge basic director duties to the company, then the following questions arise:

- why did the European Court of Justice in Case C-322/12 "GIMLE" (2013), state that the 4th Directive for which true and fair view is the standard which sets a <u>minimum basic standard</u> for protecting members and third parties? See extract below:-

- why would TFV in the UK and Ireland have been the standard for the accounts for the directors at all times?

- why did the European Court of Justice in GIMLE, state that true and fair view does not mean "transparency for users" even if the current value of an asset is 3,400 times the purchase price? LAPFF notes that this case reveals that the Belgian Accounting Standard setter had misinterpreted "true and fair view" for a number of years.

> **GIMLE case, 3rd October 2013**
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> *29 The Court notes that the Fourth Directive is intended to ensure <u>the coordination of national provisions</u> on the structure and content of annual accounts and reports and methods of valuation<u>, for the purposes of protecting members and third parties.</u> To that end, according to the third recital in its preamble, <u>it is designed only to establish minimum conditions</u> as to the extent of the financial information to be made available to the public (BIAO, paragraph 69).*
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> *30 The Fourth Directive <u>bases that coordination of the content of annual accounts on the principle that a true and fair view must be given</u>, compliance with which is its primary objective (Tomberger, paragraph 17; DE + ES Bauunternehmung[6], paragraph 26; and BIAO, paragraph 72). According to that principle, contained in Article 2(3) to (5) of that directive, annual accounts must give a true and fair view of the assets, financial position and the profit and loss of the company.*

Prudence and draft endorsement advice on IFRS 9

13. We note from the EFRAG staff presentation to the UK FRC on 22nd June 2015 IFRS 9 has been assessed as "prudent" on the basis that prudence means applying "caution in conditions of uncertainty". That definition of prudence appears to be a measurement attribute and accords with the IASB's new definition of prudence. However, that is not consistent with ECJ cases[7] which are concerned with prudence for a true and fair view as a recognition attribute, i.e. determining what falls to be measured. The IASB definition is limited in scope as it is following the objective of accounts per the IFRS Framework, not the objective of accounts per the 4th Directive for which true and fair view is the basic standard.

14. As a result this EFRAG definition of prudence, due to confusion on what true and fair view means:-

- is incompatible with establishing a number for profits and net assets for creditor and member protection purposes, namely lawful distributions and solvency (going

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[6] ECJ Case C-275/97 *Bauunternehmung (1999)* is clear that true and fair view (the objective of accounts) does not merely mean following what is in the directives (the process). This is relevant as LAPFF believes that as a result of defective past endorsement of IFRS by EFRAG some of those defects have been put into the accounting methods of the Directives. However, all ECJ cases are clear that the objective (true and fair view) trumps the methods, as is stated in Hoffman and Arden 1983.
[7] See for example Case C-306/99 Banque Internationale Pour l'Afrique occidentale SA 2003

concern), because expected losses which will fall after more than 12 months may be absent from provisions thus masking losses and overstating net assets

- is inconsistent with ECJ cases
- does not satisfy the true and fair view requirement of the 4th Directive

We have other substantive issues with the endorsement advice on IFRS 9, but in view of the fundamental issues raised in this letter regarding misunderstanding of the endorsement criteria, these would need to be resolved once there is a correct understanding of the endorsement criteria.

In order to arrange a meeting, conference call, or to request any further information to support the points raised above, please contact tessa.younger@pirc.co.uk.

Yours sincerely

Councillor Kieran Quinn, Chairman