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Is True and Fair of Over-riding Importance?: A Comment on Alexander's Benchmark

by

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"He dared well to despise vain things", Alexander as described by Livy (*History*, book ix, sec 17)

1. Introduction

Alexander (1999) adds clarity to the analysis of the hierarchy of principles, policies, etc. He distinguishes between a general over-riding requirement (Type A), an integrated framework (Type B) and detailed regulation (Type C). Although much of Alexander's analysis seems correct and useful, the major conclusion concerning the desirability of an over-ride in standards does not.

Alexander concludes that:

> unequivocal agreement is necessary that either the Type A criterion is superior to the Type C criterion, or the reverse (p. 252).

This seems right for both rule-makers and preparers. Then:

> supremacy of Type C specification…is inadequate in a dynamic economy, as choice or change in such regulation is inevitably without reference to a more broadly based objective.

Alexander therefore approves (p.251) of IAS 1, which gives supremacy to "fair presentation" in the preparation of financial statements. It will be argued here that, when considering an over-ride, the analysis would be improved by distinguishing between law and standards, between choice by preparers and choice/change by regulators, and

between national and international regulation. It will further be argued that choice to disobey a regulation by preparers is probably a bad thing, even in a dynamic economy, so that Type C should prevail; and that choice or change of Type C regulation (by standard setters or other regulators) can nevertheless make reference to a broadly based objective. That is, Type C should prevail for preparers (and auditors) but Type A for regulators. Consequently, it will be suggested that Alexander is wrong about the need for supremacy of Type A in the use of standards, and so is IAS 1. The argument below begins by examining the purpose and effect of the TFV over-ride in law and then the differences for standards.

2. True and fair in the UK context

The purpose of the TFV over-ride in law

The TFV (including the over-ride) in UK law provides a Type A criterion which might be used for several purposes:

i. to help preparers and auditors to choose between the available Type C rules in law or standards;
ii. to help preparers and auditors to interpret Type C rules in law or standards;
iii. to help preparers and auditors where there are no Type C rules;
iv. to force preparers and auditors to assess the need for extra disclosures beyond those in Type C rules;
v. to guide standard setters when developing Type C rules not involving the breaking of Type C rules in law (e.g. LIFO);[1]

vi. to enable or to force preparers and auditors to depart from Type C rules in standards in some circumstances;

vii. to guide standard setters when developing Type C rules in cases where they conflict with Type C rules in law; and then to enable or force preparers and auditors to follow the standard (e.g. investment properties);[2] and

viii. to enable or to force preparers and auditors to depart from Type C rules in law in undefined circumstances, even beyond point (vii).

Points (vi) to (viii) are expressed as "to enable or to force" because there is judgement involved and because preparers may *wish* to make the departures.

The TFV over-ride in law is not necessary for points (i) to (v) and is not strictly necessary[3] for point (vi). However, it is the essence of points (vii) and (viii), which is probably why the British were so keen on the over-ride as part of the Fourth Directive (Hopwood, 1990; Nobes, 1993). It would enable British standards and other practices to over-ride "foreign" rules in Directives made by lawyers, civil servants and politicians; and it would enable continual British developments despite the fact that the Directives were unlikely to change for decades.

The TFV over-ride in standards

Alexander (p.243) takes us carefully through the relationship between law and standards. As he points out, the ASB obtained and published counsel's opinion to the effect that there is "a likelihood that the court will hold that compliance with the standard is necessary to meet the true and fair requirement". In other words, the ASB actively uses the legal Type A over-ride so that its own Type C rules can outrank legal Type C rules (point (vii) above) but has been keen to establish that there is generally no Type A over-

ride of its own Type C rules by preparers (point (vi) above). Given that the ASB does not want the legal TFV to be used as a tool to avoid compliance with its standards, it is not surprising that there is no TFV over-ride written into UK standards. This is rather similar to the positions in the US, Canada and Australia, where (a) the accounting standards do not themselves contain an over-ride, and (b) the law (or the SEC) requires compliance with the standards, admittedly more clearly than legal counsel's opinion suggests is the case for the UK.

When considering whether domestic standards need to be capable of being over-ridden, the main practical purpose of the over-ride as in the Directive does not apply. That is, the standards are not "foreign"; are not made by lawyers, civil servants and politicians; and are not immutable or impervious to developments in practice. This is not to say that the TFV (without an over-ride) is unimportant in this context. The TFV, or a similar Type A criterion, can still be used to achieve the analogous points to (i) to (iv) above, and it can still be the over-riding criterion for the standard setters.

Assuming that Type C rules in standards are more detailed than Type C rules in law, the issue boils down to whether Type A criteria in law should outrank Type C rules in standards *for preparers*. As noted above, English-speaking standard setters have reached the opinion (explicitly or otherwise) that this should not be the case. This is because of their experience with preparers who used vague Type A criteria to over-ride Type C rules in order to improve the look of their financial statements (Griffiths, 1986; Tweedie and Whittington, 1990).

Conclusion on Type A over-ride

Alexander has two main arguments in favour of making Type A over-riding. First, he notes that there is "…an almost infinitely wide range of users… enterprises… situations… decisions" (p.250), so that detailed prescription will not work in forcing financial statements to provide useful information. There seem to be flaws here. It is unclear how an over-riding Type A criterion could help a single set of financial statements to satisfy more of the infinity of needs than over-riding Type C rules would (given that Type A would still be present, requiring disclosures, and so forth). Also, as noted above, experience suggests that any over-riding Type A criterion will be used by some preparers to mislead rather than to inform.

Alexander's second main argument is that:

> if regulation is going to be changed…then some *over-riding* criterion greater than that enshrined in regulation itself must, as a matter of logical necessity, be employed to decide on the changes (p.250, emphasis in original)

Taken literally, Alexander scores an own goal here. He appears to be saying that the Type A criterion should not be enshrined in regulation but should be employed by the regulator. I agree. However, he probably means that a Type A criterion greater than the Type C rules should be enshrined in legislation. This, of course, is not a logical necessity because the regulators could use a Type A criterion when making Type C rules whether or not it was enshrined in regulation as over-riding for preparers and auditors.

3. IAS 1

I now turn to international standards. I do not wish to defend the detail of E 53 any more than Alexander does (p. 250). However, this does not mean that IAS 1 is right.

Alexander quotes Karel Van Hulle (1997) and Sir David Tweedie *(Accountancy, 1997)* as reporting that the US, Canada, Australia and Germany were against an over-ride in IAS 1, whereas the UK and most other Europeans were in favour. The reports are slightly inaccurate. The Scottish representative on the IASC Board (Sir David) did indeed speak passionately in favour of an over-ride, but the English representative[4] spoke passionately against.

The arguments against an over-riding Type A (e.g. TFV) criterion relating to a domestic standard have been made above. First, TFV can still be used by preparers for purposes (i) to (iv) (see section 2). Second, TFV can still be the over-riding criterion for law-makers and standard setters (point (v)). Third, one can still have an over-riding TFV in law (points (vii) and (viii)). Fourth, the experience of standard setters in the English-speaking world (including the UK) suggests that it is a bad idea to allow preparers a means to break standards. One should not lightly dismiss the views of experienced standard setters in the US, Canada and Australia; and one should judge the ASB by its domestic actions (i.e., obtaining and publishing counsel's opinion, as examined above) rather than by its international words. These standard setters have observed that, for every case where a TFV over-ride of a standard would force a preparer to depart from a "wrong" Type C rule, there would be dozens where a preparer would contrive to depart from a "right" Type C rule. So, this form of the over-ride would make financial reporting worse.

An alternative approach to allowing the rare necessity of an over-ride of Type C rules is for preparers to disclose the problem and its effects, even to the extent of pro forma financial statements. If the issue is substantial and not extremely rare, then the standard setters can change the Type C rule or issue an interpretation of it.

The case against a TFV over-ride becomes even stronger in an international standard than in a domestic standard. Alexander reports (p. 245) that he and I have separately argued that there are many European meanings to TFV; but that others have argued that there is one “European TFV” which might be different from a British TFV. Either way, there is agreement that the interpretation of TFV differs internationally. It seems clear, too, that there is greater scope for international variation in the interpretation of a Type A criterion than of a Type C rule. Consequently, a Type A over-ride in IAS 1 will be interpreted with even more variance internationally than nationally, so that Type C rules will be over-ridden to different degrees and in different ways in different places even in similar circumstances. Users of sets of financial statements prepared in different countries but all under IAS rules would presumably prefer to reduce such differences.

A second international issue concerns oversight and enforcement. The cost of a Type A over-ride in standards (i.e. abuse of it) is likely to be minimised if there is an effective oversight and enforcement mechanism. To the extent that there is an over-ride of Type C rules in standards in the USA or the UK (see above and Alexander, sections 3 and 6), it is now little abused (or even used) because of legally backed oversight and enforcement in the respective countries by the Securities and Exchange Commission and the Financial Reporting Review Panel. There is presently no such body on an

international basis to oversee and enforce IAS, as has been lamented by the World Bank and others (*Accountancy*, 1999). This increases the likelihood of abuse.

Incidentally, although IAS lacks a specific legal context for a Type A over-ride to be written into, this does not mean that an over-ride has therefore to be put into IAS itself. As noted above, four of the uses of the Type A criterion for preparers (see points (i) to (iv) of section 2) do not rely on an over-ride, and two other uses (points (vii) and (viii)) not relevant in the absence of a specific legal context. The remaining use for preparers (i.e. for the over-ride of Type C rules in standards) is the one that I believe is inappropriate anyway. For standard setters with no specific legal context, insertion of an over-ride into standards is also not appropriate, given that standards are addressed to preparers and auditors not to standard setters. For the latter, the Type A criterion can be made paramount in other ways, such as being written into a conceptual framework.

In addition to the above arguments against an over-ride in IAS 1, there was the political point that inserting an over-ride would be used by those opposed to IOSCO endorsement of IASC's standards to suggest that the standards were so loose that they contained an in-built non-compliance device (e.g. FASB, 1999, p.47). There is no reason why Alexander should have included this in his logic, but it is relevant in the wider scheme of things for those who believe that the spread of IAS would be likely to improve accounting around the world.

Fortunately, the problem with IAS 1 was mitigated in the final drafting discussions by adding a requirement to disclose the reasons for departure and details of the financial effect (IAS 1, para. 13 (c) and (d)). It might be concluded that there is little difference between (i) breaking a Type C rule with a full financial explanation of why

this is necessary to comply with a Type A criterion, and (ii) complying with a Type C rule with a full financial explanation of how different things would have looked if one had complied with the Type A criterion. In a world of universally honest preparers, fully independent auditors and fully effective overseers, one might be comfortable with indulging a philosophical preference for the former. However, for practical and political reasons, the latter might have been better.

4. Examples of Type A/Type C conflict

Some examples may be useful to illustrate the dangers of a Type A over-ride in standards. IASs are chosen as the context.

IAS 12 (paras. 15 and 53) imposes Type C rules whereby an enterprise must account for deferred tax on a temporary difference arising on the revaluation of an asset; and the amount should not be discounted. Some British preparers and auditors (and standard setters) claim[5] that this is "wrong" particularly in the normal case where there is no intention to sell the asset and where anyway roll-over relief could be claimed to postpone any tax on a capital gain. It is "wrong" because the resulting credit balance would not meet the definition of a liability,[6] in that there is no obligation to a third party at the balance sheet date. Furthermore, for such a long-dated "liability", it is badly misleading not to discount it, particularly given the requirement to discount pension liabilities (IAS 19, para. 54) and other types of provisions (IAS 37, para. 45). One could argue that zero would be a better estimate of any liability rather than the full nominal amount. Presumably, the consciences (or inclinations) of British preparers or auditors

might require them to use the Type A over-ride in IAS 1 in order to disobey the Type C rules of IAS 12.

Again, IAS 19 (para. 83) contains a Type C requirement to take account of estimated future pay rises when calculating defined benefit pension liabilities. Some German preparers and auditors claimed[7] that this is "wrong" because there is no obligation to make the pay rises. This seems to be a mistaken[8] argument, but that is not the issue here.

If preparers or auditors honestly believe (or can plausibly claim to believe) that a Type C rule leads to "wrong" accounting, then Alexander and IAS 1 would require them (or, in the bracketed case, allow them) to break the Type C rule in order to comply with the Type A criterion. If this hierarchy were taken literally and seriously, chaos would result. British companies could break IAS 12 and German companies could break IAS 19 while still claiming compliance with IAS. It would be difficult for auditors to qualify their opinions, even if they wanted to; and there would be no review/enforcement mechanism beyond that.

5. Conclusion

While agreeing with many of Alexander's arguments and conclusions, I challenge Alexander's conclusions that Type A criteria should over-ride Type C rules in standards, and that IAS 1 is therefore a good standard in this respect. The problem arises because of the lack of sufficient distinction in the following cases:

i. between a Type A over-ride in law and one in standards;

ii. between a Type A supremacy for regulators and a Type A over-ride for preparers; and

iii. between a national setting and an international setting

Consequently, Alexander's two main arguments (inflexibility/stultification and change to regulation) do not work. First, Type C rules in law may be stultified but this is not necessary for standards. They can be changed reasonably quickly or an interpretation can be issued. In the meantime, supposing that the standard setters had already been using the Type A criterion to make the Type C rules, flexibility in terms of a Type A over-ride for preparers would be likely to entail higher costs in terms of abuse than benefits in terms of a rare case of better accounting. Secondly, although supremacy of a Type A criterion is necessary for coherent change to Type C rules, it is necessary in the minds of the regulators not as an over-ride for preparers.

The arguments in this comment paper suggest the following:

a) A Type A criterion is useful in law or standards or both, so that preparers and auditors can interpret Type C rules and fill gaps.

b) A Type A criterion should be used by legislators or standard setters when making Type C rules. (Obviously this means that Type A over-rides Type C).

c) Within a law, a Type A over-ride of the law's Type C rules is useful, assuming that there are reasonably detailed Type C rules in standards.

d) The law should not contain a Type A over-ride of Type C rules in standards.

e) Standards should not contain a Type A over-ride of Type C rules in standards.

f) Conclusions (d) and (e) apply particularly if there is no effective oversight or enforcement mechanism.

g) Conclusion (e) applies particularly in an international setting where the Type A criterion would be interpreted variously.

In the USA, (a), (b)[9] and (e)[10] are complied with, and the rest are not relevant. (Incidentally, the suggestion that the US and other standard setters comply with (b) by *using* a Type A criterion does not mean that they always publish the "right" Type C rules. Sometimes the standard setters are overcome by practical or political considerations). In Australia and Canada, (a), (b), (d) and (e) are complied with, and the rest are not relevant (including (c) because there are no Type C rules in law). In the UK, (a), (b), (c) and (e) are complied with. In effect, so is (d), given counsel's opinion and lack of relevance of (f). As in the other countries, (g) is also not relevant. Consequently, all these countries satisfy my desiderata. IAS 1 is the odd one out. There is compliance with (a) and (b), and (c) and (d) are not relevant. However, (e) is broken, which is particularly serious given that (f) and (g) are relevant. Fortunately, the problem with IAS 1 is mitigated by compulsory disclosures.

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[1] SSAP 9 suggests that LIFO will normally not give a true and fair view, which therefore normally over-rides the permission to use LIFO in the Companies Act 1985, Schedule 4, para. 27 (2).
[2] In order to give a true and fair view, SSAP 19 requires the annual revaluation of investment properties, with no depreciation. The latter point over-rides the requirement to depreciate all fixed assets with limited useful lives in the Companies Act 1985, Schedule 4, para. 18.
[3] Because a legal requirement to give a TFV would over-ride a standard even without a TFV over-ride of law in law.
[4] That is, the present author.
[5] The following were arguments used by the UIC representatives on the Board of the IASC during the debate leading up to IAS 12 (revised). Such arguments can also be seen in British and the other submissions to the IASC on E 49 which are on public record.
[6] IASC, *Framework*, paras. 49, 60, 91.
[7] See, for example, FEE (1999), p.40.
[8] This is mistaken because the existence of an obligation is necessary to establish that there is a liability (*Framework*, para. 49) rather than to measure the size of the liability. There is no doubt that there is a pension liability in this case (irrespective of future pay rises); the issue is how to arrive at the best estimate of it. There is a probability that there will be future pay rises, so they need to be taken into account in the estimations.
[9] Although Alexander notes (p.248) that "fair presentation" need not be used by the FASB, there are other statements of purpose (i.e. Type A criteria) in the FASB's Framework.
[10] To the extent that (e) is not complied with because of AICPA rule 203 (Alexander, p. 248) then this is sorted out by SAS 69 and because (f) does not apply.