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# True and fair view in financial reporting: search for the Holy Grail

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# Agenda

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3. Financial statements
4. Statutory audit
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# 1. Introduction

# Financial reporting and standard-setting

- Financial reporting has become very sophisticated and standard setting in accounting and auditing is carried out in a very professional manner
- The high quality of the standards produced by the IASB and the IAASB/IESBA is generally recognised
- Nevertheless, questions are raised
  - about the relevance of the information contained in financial statements
  - about a perceived lack of independence of audit firms and about the role of the statutory audit
- Is financial reporting as it exists today still fit for purpose?

# Changing environment: new risks

- Political changes
  - *Rising populism, nationalism, protectionism*
  - *Antiglobalisation*
- Demographic changes
  - *Ageing population*
  - *Migration*
- Climate change
  - *Natural catastrophes*
  - *Water shortages*
- Technological changes
  - *Fourth industrial revolution*
  - *Data analytics, cyber security*

# Has financial reporting a role to play in this changing environment?

- Translating economic reality into a meaningful set of numbers is a challenge and implies making choices
- Through financial reporting, undertakings communicate with a multi-stakeholder environment
- It matters how this communication is made and which message it contains
- Financial reporting does not only report facts but also influences behaviour
- The standards regulating financial reporting are therefore not politically neutral and it would be wrong to give the impression that they are

# Some helpful messages

- "*Not everything that can be counted counts and not everything that counts can be counted*" (Albert Einstein)
  - Accountants should account for what counts, i.e. for what matters
- "*You don't win a marathon by being first every quarter of a mile"* (Lord Paul Myners, former Treasury Minister, UK*)*
  - A too short-term focus may not get us there
- *"My colleagues and I are totally committed to a business strategy that generates profits while contributing to the well-being of the planet and its people. We see no alternative."* (Mark Moody-Stuart, former Chairman Shell)
  - Financial reporting and sustainability go hand in hand

# 2. Financial communication

# Financial communication

- Financial reporting traditionally takes place through the financial statements, accompanied by an annual report and an audit report
- As financial statements are prepared on the basis of accounting standards, undertakings are no longer free to decide how to present information in the financial statements
- Many undertakings have sought other means to communicate with stakeholders (sustainability reports, integrated reports)
- Governments are imposing the disclosure of additional non-financial information outside the financial statements
- Financial communication becomes complex and possibly misleading when the information provided outside the financial statements is voluminous, not-standardised, unaudited and sometimes more important than the information contained in the financial statements

# 3. Financial statements

# Objective of financial statements (IAS 1)

- To present fairly the financial position, financial performance and cash flows of the undertaking
- Fair presentation requires the faithful representation of the effects of transactions, other events, and conditions **in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the conceptual framework for financial reporting**
- The application of IFRSs with **additional disclosure**, when necessary, is presumed to result in financial statements that achieve a fair presentation
- In **extremely rare circumstances**, management may conclude that compliance with an IFRS requirement would be misleading. In such a case, the undertaking **must depart** from the requirement, with detailed disclosure of the nature, reasons and impact of the departure

# Objective of financial statements (EU Accounting Directive)

- The financial statements must give a true and fair view (“imagen fiel”) of the undertaking’s assets, liabilities, financial position and profit or loss
- Where the application of the legal requirements is not sufficient to give a true and fair view, such **additional information** as is necessary to comply with the true and fair view requirement must be given in the notes to the financial statements
- Where **in exceptional cases** the application of a legal requirement is incompatible with the obligation to show a true and fair view, that requirement **must be disapplied** in order to give a true and fair view
- The disapplication must be disclosed in the notes together with an explanation of the reasons for it and of its effect on the undertaking’s assets, liabilities, financial position and profit or loss

# Are financial statements fit for purpose?

- Financial statements have become very complex as they are prepared on the basis of standards that are very detailed and prescriptive
- Financial statements are no longer fit for purpose, as they :
  - do not take account of new developments, such as climate change
  - ignore important assets, such as human, social and natural capital
  - fail to recognise the information needs of those stakeholders, that are interested in the sources of value creation
  - are too much concerned with the narrowly defined interests of shareholders/investors and the short-term needs of financial markets
  - focus primarily on historical performance
  - do no sufficiently reflect the business model of the undertaking

# True and fair view override as solution?

- Both IAS-1 and the EU Accounting Directive recognise the true and fair view override
- Can the true and fair view override be used to correct the picture delivered by the financial statements?
- Although the override is not subject to specific authorization, the financial reporting framework has been designed so as to make it difficult for undertakings to use the override
- Annual reports sometimes indicate that the financial statements do not correctly reflect the economic position of the undertaking and try to correct this with the use of non-GAAP measures or other disclosures
- The override could be used as a means to force standard setters to adapt their standards to a changing environment

# Imperfect solutions

- The importance of non-financial information is generally recognised and has led to new initiatives such as sustainability reporting, ESG reporting, integrated reporting
- Although experimentation is useful and the additional information is welcome, there is a lack of harmonisation which makes it difficult for stakeholders to compare and to trust the information, which is often unaudited
- Unless values, such as non-tangible assets or the impact an undertaking has on the environment, are integrated in the financial statements, it is unlikely that financial reporting will influence corporate behaviour as these values or impact are not reflected in the balance sheet and therefore do not influence the bottom line

# Need to adapt the accounting framework

- Are our definitions of "asset" and "liability" still right?
  - Asset: present economic resource controlled by the entity as a result of past events
  - Liability: present obligation of the entity to transfer an economic resource as a result of past events
- Should we not include more non-tangible items in the balance sheet, i.e. give them a value and consider human, social and natural capital as assets?
- Does recognising value without considering the full costs of sustainability and the consumption of scarce resources not contradict the matching principle?
- Should we not reinstate the prudence principle and look at it from a sustainability point of view?

# Example: long-term investment debate

- The IASB considered the question of a separate treatment of long-term investments in the context of the revision of its conceptual framework and concluded:
- "*It is not the role of the standards to encourage or discourage any type of investments. Instead standard-setting decisions are driven by the need for entities to provide useful information*"
- "*The Board decided not to refer explicitly to the business activity of long-term investments for the following reasons:*
  - *Referring explicitly to any particular business activity would, inappropriately, embed excessive detail in the Conceptual Framework, and*
  - *The Conceptual Framework does not refer to any other business activity"*

# The IASB's arguments are not convincing

- The information provided in financial statements is not useful when it misrepresents the business model of the undertaking
- Recognising a long-term investment business model in the conceptual framework does not lead to excessive detail, as there is no need to go beyond the recognition of the principle
- A one size-fits-all model only makes sense if there are no differences in substance
- Treating different business models as if there were only one model can never lead to a true and fair view

# Insurance as an example

- Asset-liability management plays an important role in a risk based solvency regime
- In order to reduce the duration gap, insurance undertakings must match the duration of their investments with the duration of their liabilities
- To the extent that the liabilities are illiquid, it makes no sense to value the investments matching those liabilities at fair value
- Not recognising this long-term business model misrepresents the financial situation of an insurance undertaking and creates artificial volatility

# 4. Statutory audit

# Statutory audit (ISAs)

- The auditor must form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework
- In order to form that opinion, the auditor must conclude as to whether he/she has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error
- The audit report must include a reference to **key audit matters**, i.e. those matters that were of most significance in the audit of the financial statements

# Statutory audit (EU Audit DR and RE)

- The auditor must provide an opinion on whether the financial statements give a true and fair view in accordance with the relevant financial reporting framework and, where appropriate, whether the financial statements comply with statutory requirements
- The audit report must refer to **any other matters** to which the auditor draws attention by way of emphasis without qualifying the audit opinion
- The audit report must provide a statement on any material uncertainty relating to events or conditions that might cast significant doubt about the undertaking's ability to continue as a **going concern**
- "The scope of the statutory audit does not include assurance on the future viability of the audited undertaking or on the efficiency or effectiveness with which the management or administrative body has conducted or will conduct the affairs of the entity" (Art. 25a Audit RE)

# Is the statutory audit still fit for purpose?

- Although the information provided in audit reports has improved considerably, the audit expectation gap is wider than ever, particularly in the case of audits of PIEs
- Auditors need to express an opinion on whether the information provided in the financial statements and in the annual report serves a useful purpose not only for shareholders but also for other stakeholders
- Stakeholders, including shareholders, are not only interested in what happened in the past but also in what is likely to happen in the future
- Whilst shareholders might be primarily interested in whether the directors properly carried out their duties, they – and other stakeholders – also want to know whether there are risks threatening the undertaking’s business model, its future performance, solvency or liquidity

# New role for the statutory audit of PIEs?

- The primary responsibility for communicating with stakeholders rests with the Board
- In order to make this communication useful, the Board should assess on an annual basis whether there are any threats to the sustainability of the undertaking’s business model
- In its communication to stakeholders, the Board should indicate that it has caried out this assessment and disclose any significant risks
- The auditor should express an opinion on whether the Board has carried out this assessment and whether there are any reasons to believe that the assessment of the Board is incorrect or overly optimistic
- The auditor – acting in good faith – should be protected from liability for expressing an opinion on the Board’s assessment

# Extract from Shell's Audit Report (2017)

"We have nothing to report in respect of the following information:

- The disclosures in the annual report that describe the principal risks and cross refer to where there are explanations of how the risks are being managed or mitigated;
- The Director's confirmation in the annual report that they have carried out a robust assessment of the principal risks facing the entity, including those that would threaten its business model, future performance, solvency or liquidity;
- The Director's statement in the financial statemens about whether they considered it appropriate to adopt the going concern basis of accounting in preparing them, and their identifaction of any material uncertainties to the entity's ability to continue to do so over a period of at least twelve months from the date of approval of the financial statements"

# Need to adapt the auditing standards and the standards on ethics

- Should the standards not also address the business model of audit firms:
  - requiring the firm to provide the necessary resources in the firm to ensure a high quality audit?
  - requiring the firm to ensure that the incentive system within the firm does not endanger a high quality audit?
  - prohibiting an audit firm from carrying out a statutory audit if most of its business is consulting?
- Should auditors not be required to express an opinion on whether the undertaking is likely to continue as a going concern?
- Should auditors not be required to express an opinon on whether they believe that no fraud has been committed?

# 5. Standard setting

# The challenge of standard setting

- IAS/IFRS and ISAs have become so complex that only experts have the courage to contribute to the standard setting debate
- As the SSBs are primarily composed of experts with a similar profile, it is unlikely that they can be leaders of change
- IAS/IFRS may become irrelevant if sustainability reporting is the way forward and the standards do not change
- Because of the importance of financial reporting, the SSBs should have a multi-stakeholder composition and be subject to public interest oversight
- Although the independence of the SSBs must be respected, the public interest oversight should be able to call the SSBs to order if the standards are no longer fit for purpose

# 6. Concluding observations

# Concluding observations

- The world is changing rapidly and communication channels are becoming more sophisticated
- Financial reporting as a means of communication can influence societal developments and standard setters should be aware of this
- Although financial reporting has improved, there is a need to review the conceptual framework upon which accounting standards are based in order to incorporate a long term and forward looking approach
- In order to reduce the audit expectation gap, a redefinition of the role of the auditor is necessary
- The required changes imply changes in the way accounting and auditing/ethical standards are set
- Integrating a sustainability approach in financial reporting is no longer a luxury but a must

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