SOME APPROACHES TO A 'TRUE AND FAIR VIEW': A REVIEW

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ABSTRACT

After an initial introduction indicating the apparent centrality of the true and fair view concept to UK accounting and auditing practice this paper explores, initially, some mainstream approaches to the meaning of the statutory phrase 'true and fair view'. This is undertaken by analysis under the following headings:

- *The Statute*
- *Company Law Committees*
- *Case Law*
- *Some Views from Academia*
- *The Institutional View (Auditing Standards and Guidelines)*
- *The View of Some Practitioners*
- *The Industrialists' View.*

This analysis reveals some points of similarity between the points of view expressed by some mainstream commentators. It also reveals some conflicts. The similarities and conflicts are reviewed in Conclusions.

INTRODUCTION

The importance of the concept of a true and fair view to auditing and accounting in both the Republic of Ireland and the UK stems from Paragraph 3 of Article 2 of the *European Community (EC) Fourth Company Law Directive*. The English version of this paragraph is as follows:

> 'The annual accounts shall give a true and fair view of the company's assets, liabilities, financial position and profit or loss.'

This paper is primarily intended to review a number of approaches to true and fair view to identify points of agreement and areas of conflict. The approaches considered can be classed as falling within the 'mainstream'. This is the traditional viewpoint that privileges the providers of capital and their agents. An examination of the notion of true and fair view from other viewpoints will yield other insights. Such other views include those of the Critical Accounting School and are considered by the present author to be potentially particularly fruitful.

THE STATUTE

The *EC Fourth Directive* made true and fair view the accounting requirement throughout the EC. However, the Directive does not contain a definition of true and fair view. Furthermore, neither the Irish nor the UK statutes that enact the *Fourth Directive* define true and fair view.

The fact that the statute refers to a true and fair view rather than the true and fair view suggests that there may be a range of acceptable views. The range of acceptability may be linked with the notion of materiality.

The question arises whether true and fair view is to be interpreted literally or in a technical manner. It is possible that when the *Joint Stock Companies Registration and Regulation Act 1844* was introduced requiring the preparation of 'full and fair' balance sheets the literal meaning of 'full and fair' was the same as the technical meaning. However, the increased complexity of business transactions is reflected in the increased complexity of accounting practice necessary to capture those transactions. Accounting practice has been developed for the informed or sophisticated user of financial statements. This has led to a divergence between the literal meaning of true and fair view and its technical meaning. The case of *In Re Press Caps Ltd* (which is discussed below) hinged upon this divergence.

The law currently fails to recognise this divergence between the literal and technical interpretations of the statutory phrase with dysfunctional results. For example, accounts give a view appropriate for use by the informed, technically proficient user: this view will be unsuitable for use by the unsophisticated investor.

COMPANY LAW COMMITTEES

The company law committees in question are the Cohen Committee of 1945 and the Jenkins Committee of 1962. The Cohen Committee endorsed the opinion submitted by the Institute of Chartered Accountants in England & Wales that:

> 'A balance sheet is ... an historical document and does not as a general rule purport to show the net worth of an undertaking at any particular date...'

Interestingly the Jenkins Committee was, on balance, in favour of retaining historical cost accounting as the basis for published financial statements although some of the deficiencies of this paradigm were alluded to in the following words:

> 'Accounts prepared on the historical cost basis may need to be accompanied by supplementary information in order to give shareholders the true and fair view required by the Act.'

Evidence adduced by academics to the committee was against the retention of historical cost accounting. For example, Professor Baxter said:

> 'It is clear that balance sheet values of many assets have drifted far away from current values ... In fairness to shareholders, and as a check on management inertia some reform appears to be needed.'

Nevertheless, despite Trade Union and Chambers of Commerce support of the latter perspective, the committee endorsed the view of the English Institute that:

> 'It has long been accepted in accountancy practice that a balance sheet is an historical record and not a statement of current worth.'

This indicates that a technical interpretation of true and fair view was accepted over a literal interpretation by the Jenkins Committee, as well as the Cohen Committee before it. This was noted and challenged by the President of the New South Wales Court of Appeal in these words[1]:

> 'It is a little difficult for a lawyer to detect why either expediency or the practice of the accountancy profession can authorise departure from ordinary principles of construction applicable to a statute ... where is there room for the 'historical record' doctrine as a fully satisfying compliance with the statute? ... To me, the word 'true' (curiously enough) simply means what it says — it is for the legislature and not accountants and directors to alter the natural meaning of the statute ...'

CASE LAW

In Re Press Caps Ltd

Following *In Re Press Caps Ltd* [(1949) Ch 434] it has been claimed (for example, Hoffman & Arden 1983, and Bird 1982) that accounts give a true and fair view if they comply with accounting conventions. However, Williams (1985) points out that 'the test was never applied to the balance sheet ... the matter was not discussed in that way'.

Given the views adverted to above that accounts give a true and fair view if they comply with accounting conventions, the remarks of the Attorney General for the prosecution in the following case of *Rex v Kylsant* [(1932) 1 KB 442] are noteworthy.

Rex v Kylsant (The Royal Steam Packet Company)
In his summing-up the Attorney General made the following observations:

> 'Technical rules of accounting are admirable things but they are the letter and not the spirit. It is no good observing merely the letter ... If the documents convey to a reasonably intelligent person a false impression, all the technical rules of accountancy may be observed and at the same time the accountants' profession has failed to carry out its primary and obvious duty ...'

Argyll Foods Ltd
The accounting treatment at issue conformed with neither generally accepted accounting principles nor the statutory requirements. Nevertheless, the auditors were of the opinion that the accounts did show a true and fair view. Although there was no suggestion of *mala fides*, and despite the supporting evidence of the company's auditor and an expert witness, the magistrates found the company (in the person of its Finance Director) guilty of contravening *CA48*. However, the Court gave the Finance Director a mere 12 months' conditional discharge — and eight summonses against other directors of the company were adjourned *sine die*. It appears that the magistrates concerned considered that true and fair view is a matter of whether the accounts are misleading.

Following the trial, the DTI issued a statement that included the admission that it sees:

> '... nothing inconsistent between the law ... and the disclosure and other requirements elaborated by Accounting Standards by way of guidance statements and indicators of best practice. It does, however, consider it axiomatic that any emphasis of substance over form must not be at the expense of compliance with the law.'

Supporting the DTI view are intemperate remarks published by the Law Society in 1986 which condemn substance over form as 'contrary to law', 'dangerous', 'subjective', 'undesirable' and vague'. However, the

DTI statement conflicts both with the interpretation of *In Re Press Caps Ltd.* given above and the extract from the judgement in *Devlin v Slough Estates Ltd.* below.

It is arguable that the *CA85* overrides the DTI statement. Thus, following Substance over Form is following the law because Substance over Form is recognised by the Act. It is almost inconceivable that the drafters of the Act were unaware of the DTI statement.

Thus, we can discern here a pair of conflicts between special interest groups, namely the legal profession and the accounting profession, and the DTI and the accounting profession. Substance over Form denies the 'reality', and validity of the lawyers' interpretation. This convention designates legal form as inferior to the accountant's judgement of what constitutes an economic 'reality'. It is understandable that lawyers resent this.

Devlin v Slough Estates Ltd.

> 'Insofar as the formulation of accounts involves matters of judgement ... that is a matter of business judgement. The Court does not interfere with the business judgement of directors in the absence of *mala fides* ...'
>
> — Dillon, J in *Devlin v Slough Estates Ltd.*, *The Times* (16/6/82).

The clear implication here is that true and fair view is a matter of the exercise of judgement by people with the responsibility for exercising that judgement (provided only that they act in good faith). Arguably, the Court will not interfere because such people are acting in a (privileged) quasi-judicial capacity. This seems to re-emphasise the role of accounting opinion: if businesspeople act in good faith and are reasonably well informed it is difficult to see how they could fail to have regard to accounting conventions.

Shearer v Bercain Ltd.

The Principal Advisory Accountant to the Inland Revenue is reported as saying in *Shearer v Bercain Ltd.* [(1980) STC 359] that true and fair view is 'largely a matter of personal opinion'. This emphasis on the exercise of personal judgement echoes the sentiments of the judge in *Devlin v Slough Estates Ltd.* Similarly, Nicholas, J in the New South Wales case of *Stevinson Hardy & Co Ltd. v Smith Wylie (Australia) Ltd.* [(1939) 39 SR (NSW) 388] found that the balance sheet values of assets were merely a matter of opinion (and that inaccuracy was an irrelevancy provided only that the valuations were honestly made).

Lloyd Cheyham & Co. v Littlejohn & Co.

In *Lloyd Cheyham & Co. v Littlejohn & Co.* (1986) Woolf J made the following observations:

> 'While Statements of Standard Accounting Practice are not conclusive ... they are very strong evidence as to what is the proper standard which should be adopted ...'
>
> '... third parties in reading the accounts are entitled to assume that they have been drawn up in accordance with the approved practice ...'

These statements strongly support the view that true and fair view can be achieved through conformity with contemporary accounting practice.

SOME VIEWS FROM ACADEMIA

Bird & Rutherford (1989), Lee (1986) and Pennington (1983) imply an adherence to the notion of realistic ontology. This position is given in the following extract from Sherer & Kent (1983):

> 'Truth and fairness is concerned with the faithfulness with which the reported financial information depicts the realities of the operations of the enterprise and its state of affairs: in other words, do the accounts provide a reasonable correspondence with reality ... ?'

However, in Bird and Rutherford there is a qualification of this position of 'Representational Faithfulness' by insisting on disclosure of the framework in which the financial statements are constructed. This implies that multiple realities exist – one (at least) in an historical cost system, one (at least) in a current cost system, and so on. This idea is worthy of further exploration, but lies outside the mainstream perspective adopted within this paper.

Again from Sherer & Kent (1983):

> 'The balance sheet is not, as is occasionally believed, a statement of the realisable value of the undertaking, nor is it intended to be a direct means of valuing the share capital or of making forecasts.'

This is further reinforced by the following extract from Williams (1985):

> '*In Re Press Caps Ltd* ... In the High Court, the judge had made an order ... because he felt that the balance sheet

> understated the value of the company, and therefore would undervalue its shares, on this basis. But the Court of Appeal overturned his decision.'

A further insight from Sherer & Kent (1983):

> 'The difficulty from the auditor's point of view is that, in his attempts to fulfil his function, he cannot step beyond the confines of accounting as it currently exists and which sees truth and fairness as being defined in terms of existing accounting principles and standards. The auditor is thus constrained by the practice of financial accounting.'

This latter point is well made. Transactions are 'encoded' into the accounts according to the current rules of financial accounting. The user, knowing these rules, is presumed to be able to 'decode' the accounts and extract meaning. Specifically, an argument is that the user can arrive at an appreciation of the transactions (and their effects) entered into by the organisation through this decoding process.

Hence, one might be able to create some previously unconsidered accounting process to deal with a type of transaction or situation that would lead, in the opinion of the creator of this new and appropriate process, to a true and fair view if the users only knew, and understood the effects on the accounts, of this new rule. However, they will neither know, nor understand the effects on the accounts, of the rule until the process by which accounting innovations are admitted to the canon, so to speak, has been completed. To this extent, then, there is a temporary constraint. Some may argue that there have been occasions when the constraint has been more than temporary and could cite the whole UK inflation accounting debacle in evidence.

Woolf (1990) claims '... it is clear ... that SSAPs should be taken into account by the auditor in reaching a decision on whether financial statements give a true and fair view'.

The 1980 auditing standard implies that compliance with SSAPs is of crucial importance in achieving a true and fair view. In addition Mautz & Sharaf (1961), Chastney (1975), Rutherford (1985) and Walton (1991) tend to support the idea that true and fair view is defined by generally accepted accounting principles (GAAP).

> 'The inherent subjectivity with which 'fair' has to be assessed represents the auditor's most severe challenge, rather than a licence to authenticate any of a range of views. He must consider the

> overall impression created by the accounts as a whole; the fact that every individual figure may be justified does not automatically mean that the total picture is fair.'

For example, there may be individually immaterial errors in, say, stock, debtors and creditors that lead, overall, to a misleading liquidity position.

> 'We thus have a statutory formulation which although stated as an objective requirement involves, ... a good deal of subjective assessment ... This imposes a great burden on the auditing profession ...'

'A great burden' may be considered to be something of an understatement.

Hatherley & Skuse (1991) suggest that in inflationary times the limitations of the Historical Cost Convention in yielding a true and fair view should be emphasised in the audit report. The deficiencies, and subjectivity, of this and other accounting conventions are discussed later.

Writing of the requirement, where necessary in order for the financial statements to give a true and fair view, to override specific format and disclosure regulations within *CA85*, Hatherley & Skuse (1991) state:

> '... the Act appears to link the "true and fair view" with both the sufficiency of the information provided by the presentation and disclosure of the financial statements and the appropriateness of the accounting principles to the particular circumstances of the business.'

These authors suggest the following definition of true and fair view:

> 'Financial statements of an enterprise give a true and fair view if they, together with related notes, are sufficiently informative of matters that affect their use, understanding and interpretation by those for whom they are intended, and they are prepared in accordance with accounting principles appropriate to the circumstances of the business.'

The need to consider the users' informational needs is also alluded to by Skerratt (1982) who makes the shrewd observation that true and fair view is an inappropriate phrase to use unless the purposes for which the accounts will be used are specified. Associated arguments are reviewed later.

Edey (1971) categorises 'true and fair' as '... a term of art ...', highlighting the non-objective status of the term and hence the inappropriateness of the realistic ontology approach. Edey emphasises both the inadequacy of realistic ontology and the resulting need to appreciate the effects of the inputs to the construction of accounting reality thus:

> 'To the man in the street ... the words 'true and fair' are likely to signify that the accounts give a true statement of facts. He will be likely to associate "facts" with "actual profit" and "actual values". He does not realise that "profit" and "value" are abstractions. Before they can be conceived at all in any precise way they must be defined in such a manner that the definition contains in itself, or implies clearly, a method of calculation that could be followed in practice.'

THE INSTITUTIONAL VIEW (AUDITING STANDARDS AND GUIDELINES)

Paragraph 15 of the *Explanatory Foreword* to the *Auditing Standards and Guidelines* states:

> 'Members are advised that a court of law may, when considering the adequacy of the work of an auditor, take into account any pronouncements or publications which it thinks may be indicative of good practice. Auditing Standards and Guidelines are likely to be so regarded.'[2]

Thus, the Auditing Standards can be seen to be intended as authoritative pronouncements.

Paragraph 6 of the second Auditing Standard *The Audit Report* (1980) is headed 'true and fair' and states that:

> 'When expressing an opinion that financial statements give a true and fair view the auditor should be satisfied, *inter alia*, that:
> a) all relevant statements of standard accounting practice have been complied with, except in situations in which for justifiable reasons they are not strictly applicable because they are impracticable or, exceptionally, having regard to the circumstances, would be inappropriate or give a misleading view ...'

Adherence to SSAPs and FRSs does not, therefore, guarantee that a true and fair view will be achieved. However, the Standard appears to suggest very strongly that, except in exceptional circumstances, failure to adhere to SSAPs and FRSs will almost certainly lead to a failure to achieve a true and fair view.

This interpretation is supported by the opinion of Counsel (Arden, 1993) in the Appendix to the *Foreword to Accounting Standards* released by the Accounting Standards Board. Specifically, Paragraph 8 of the Opinion states: 'The status of accounting standards in legal proceedings has also in my view been enhanced by the changes in the standard-setting process since 1989'. *A fortiori*, the final Paragraph 15 states:

> 'Experience and legislative history ... have both illustrated the subtlety and evolving nature of the relationship between law and accounting practice. Accounting standards are now assured as an authoritative source of the latter. In consequence, it is now the norm for accounts to comply with accounting standards. I would add this. Just as a custom which is upheld by the courts may properly be regarded as a source of law, so too, in my view, does an accounting standard which the court holds must be complied with to meet the true and fair requirement become, in cases where it is applicable, a source of law in itself in the widest sense of that term.'

THE VIEWS OF SOME PRACTITIONERS

Appendix 1 lists some of the considerations in assessing 'true and fair', identified in the Coopers & Lybrand audit manual. The matters dealt with can be summarised as follows:

- Unambiguous disclosure
- Appropriate degree of aggregation
- Correspondence with the firm's circumstances
- Substance over form
- Absence of manipulation by management.

In addition, the Coopers & Lybrand manual states that 'artificial transactions should not be accounted for as though they were real'. This is a restatement of the convention of substance over form.

The Neville Russell audit manual states that 'true and fair' defies definition. This supports both the view of Flint (1982) who argues that true and fair view is 'ultimately a matter of ethics or morality' and the view of the Principal Advisory Accountant to the Inland Revenue expressed in the light of *Shearer v Bercain Ltd.* [(1980) STC 359] that true and fair is 'largely a matter of personal opinion'. However, a number of specific considerations are identified in the Neville Russell audit manual:

i) Appropriateness and consistency of accounting policies
ii) Whether the amounts at which assets, liabilities, profits and losses are stated are 'fair'[3]

iii) Whether all significant information has been disclosed
iv) Whether the accounts are presented in a manner that assists the reader's understanding of the accounts as a whole
v) Whether relevant SSAPs have been followed.

Parker & Nobes (1991) used a questionnaire survey coupled with structured interviews with the technical partners of the 'top 20' UK audit firms. Amongst other things, they asked for an interpretation of the word 'true' and an interpretation of the word 'fair'. The results are shown in **Appendix 2.**

We can classify these words and phrases into two categories: firstly those descriptors that imply a realistic ontology, and secondly those which qualify the realistic ontology by (implicit) reference to the current accounting framework. The classification is listed in **Appendix 3.**

The 'true' descriptor 'correct, within materiality' is considered to have one component ('correct') relating to realistic ontology and one component relating to the accounting framework ('within materiality'): consequently the descriptor appears in both classes above and both components are included in the summary below. One descriptor of 'fair' (namely, 'Reasonable') is not susceptible to ready classification and is include under 'Other' in the following summary:

	True	**Fair**	**Total**
Realistic Ontology	8	11	19
Qualification	2	1	3
Other	nil	1	1
Total	10	13	23

Clearly, these practitioners subscribe to the notion of realistic ontology.

Besides being asked to interpret 'true' and 'fair', the respondents were asked whether it was standard practice in their firms to distinguish between 'true' and 'fair'. Of the 20 respondents, 16 said they did draw a distinction. Of the four who did not, two said they could if they wanted to but chose not to. This contrasts sharply with the Nobes & Parker (1991) survey of industrialists (see below).

THE INDUSTRIALISTS' VIEW

Nobes & Parker (1991) used a questionnaire survey to investigate how the financial directors of large UK companies apply the concept of true and fair view in practice. The top 900 companies listed in *The Times 1000*, 1985/86 were circularised. The response rate was 51.4%. The survey tested, *inter alia*, the hypothesis that over 50% of the directors do not distinguish between 'true' and 'fair'. The hypothesis was accepted, with 81 ± 2% of parent company financial directors and 88 ± 6% of subsidiary company financial directors. This is in marked contrast to the results of the Parker & Nobes (1991) survey of practitioners (see above).

The contrast between directors and finance directors regarding distinguishing 'true' and 'fair' evinces surprise that audit reports are not qualified more frequently than is the case. Clearly, auditors' approaches to true and fair view (in particular the notion of materiality) accommodate a range of views that is sufficiently wide to encompass the approaches to true and fair view of industrialists.

CONCLUSIONS

There is a reasonable consensus that more than a single presentation may satisfy the 'true and fair' requirement. This finds expression in the notion of materiality.

A number of commentators emphasise adherence to accounting conventions as a necessary condition for achieving a true and fair view. However, Hoffman & Arden (1983) and Arden (1993) are naive in regarding 'accounting standards' as a panacea. Compare this view with the insight of the Attorney General in *Rex v Kylsant*: 'Technical rules of accounting are admirable things but they are the letter and not the spirit. It is no good observing merely the letter ...'

A particularly striking conflict is that between practitioners and industrialists over the question of whether there is a distinction between 'true' and 'fair'. These opposing views suggest the existence of a fundamental difficulty with the true and fair view concept. One possible explanation is that practitioners hold a concept in mind when carrying out an audit that has two major components, one approximated by the word 'true' and the other approximated by the word 'fair'. The notion of 'fairness' may be associated with the attempt to satisfy the needs of a variety of users. However, industrialists with a more narrowly focused perspective may be concerned solely with presenting a view that satisfies the informational needs of a single, influential user group — hence their failure to be able to distinguish between 'true' and 'fair'.

The role, indeed the validity, of the accounting convention of substance over form is the subject of conflict between the accounting and legal professions. This debate can be viewed either as being a genuine difference of opinion stemming from different priorities and different understandings of the role of accounting or as being a power struggle between rival professional groupings.

There is some support for the idea that 'truth' is dependent on the disclosure of information and that 'fairness' stems from the adoption of appropriate accounting principles. It has also been suggested that 'truth' is therefore furnished by such statements as the profit & loss account and balance sheet while 'fairness' is added by the notes to the accounts. Many mainstream commentators adopt realistic ontology. Given the social construction of accounting 'reality', it has been argued that disclosure of the framework in which the financial statements are constructed is required. This idea with its links to Morgan's (1988) metaphorical approach is worthy of further exploration, but lies outside the range of mainstream perspectives reviewed within this paper.

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NOTES

[1] *Cited in Baxt (1968).*

[2] *The words '... a court of law may, when considering the adequacy of the work of an auditor, ...' constitute a reification.*

[3] *This is, of course, a tautology.*

APPENDIX 1
EXTRACT FROM *COOPERS & LYBRAND MANUAL 1986/7* S. 101.05 [CITED IN PARKER & NOBES (1991)]

i) All information materially affecting the view given by the accounts is properly disclosed and is unambiguous
ii) A proper balance is achieved between completeness of disclosure and the degree of summarisation that is necessary if the accounts are to be

clear and readily interpretable
iii) The information in the accounts should ensure that the conclusions which a reader might draw from it would be justified and consistent with the circumstances of the enterprise's business
iv) The accounts reflect the substance of the underlying transactions and balances and not merely their form
v) The presentation adopted in the accounts has not been unduly influenced by management's desire to present facts in a favourable or unfavourable light.

APPENDIX 2
INTERPRETATION OF 'TRUE' AND 'FAIR'.

True	Based on fact Undistorted facts Correct Complies with rules Not in conflict with facts Objective Correct, within materiality Adherence to events Factual accuracy
Fair	Not misleading (three times) Substance over form (twice) Proper reflection Putting in right context Consistent with underlying reality Ability to understand what has really gone on In accordance with rules in context Reasonable Gives right impression Whether reader receives right message

APPENDIX 3
CLASSIFICATION OF DESCRIPTORS

True	Realistic ontology: Based on fact Undistorted facts Correct

	Not in conflict with facts Objective Correct, within materiality Adherence to events Factual accuracy
Qualification	Complies with rules Correct, within materiality
Fair	Realistic ontology: Not misleading (three times) Substance over form (twice) Proper reflection Putting in right context Consistent with underlying reality Ability to understand what has really gone on Gives right impression Whether reader receives right message
Qualification	In accordance with rules in context

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