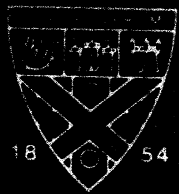


# A TRUE AND FAIR VIEW



Published for  
The Institute of Chartered Accountants  
of Scotland



by  
Gee & Co (Publishers) Limited



# **A TRUE AND FAIR VIEW IN COMPANY ACCOUNTS**

by David Flint, TD, MA, BL, CA  
Professor of Accountancy,  
University of Glasgow

Published for  
THE INSTITUTE OF CHARTERED  
ACCOUNTANTS OF SCOTLAND  
by  
GEE & CO (PUBLISHERS) LIMITED  
151 STRAND, LONDON WC2R 1JJ

FIRST PUBLISHED 1982  
GEE & CO (PUBLISHERS) LIMITED  
© 1982 DAVID FLINT  
ISBN 0 85258 223 4

This monograph, which is the fourth in a series, is published for the Research Advisory Committee of The Institute of Chartered Accountants of Scotland and does not necessarily represent the views either of the Research Advisory Committee or of the Council of the Institute.

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*Printed in Great Britain for Gee & Co (Publishers) Limited  
by The Eastern Press Ltd, London and Reading*

## *Foreword*

This series of monographs has been initiated by the Research Advisory Committee of The Institute of Chartered Accountants of Scotland. The Committee believes that, at a time both of change and of increasing interest in accounting information, these monographs will meet a need for clear explanation of some of the more difficult concepts relevant to the preparation of corporate accounting reports. All are written by acknowledged experts in their respective fields in a style which will appeal equally to the specialist and the well informed general reader. Some will be relevant to the needs of one group more than another, but they are addressed principally to accountants, bankers, civil servants, directors, financial journalists, investment managers, investment analysts, private investors, managers, trade union officials and others with an interest in accounting information. Opinions expressed by the authors are, of course, their own.



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## *Preface*

Approaching three-quarters of a million limited companies are registered in the UK. They vary in size and structure from the vast international enterprise, which draws its funds from the capital centres of the world and the securities of which are traded on one or more Stock Exchanges, to the small local business with only two shareholders. Every year each one of these companies must prepare accounts which give a true and fair view of its profit or loss and of its state of affairs. This has been the case for more than thirty years, since the coming into force of the Companies Act 1948, and yet, it is claimed, there is still widespread uncertainty about what “a true and fair view” means.

It is true that the terms are not defined in the Act, their meaning has not been the subject of judicial interpretation, and, for a concept which is so crucial to corporate financial reporting, there is relatively little discussion in either the academic or the professional journals. Although some doubts have been expressed about the adequacy or appropriateness of “a true and fair view” as a reporting standard, it has not been seriously challenged. It has a conceptual quality of great merit. Properly understood and diligently applied in practice it is well designed to serve the public interest. Not least, it recognises the cultural dependence of accounting and financial reporting, and the fact of its evolving continuously to meet the needs and expectations of the changing social and economic environment.

This monograph, prepared at the invitation of the Research Advisory Committee of The Institute of Chartered Accountants of Scotland, endeavours to explain what should be understood by “a true and fair view”, in the sense that those terms are used in relation to the accounts of companies incorporated under the British Companies Acts. The terms are also now used in relation to the accounts of other organisations but, in order to avoid elaboration in explanations where the circumstances of these other organisations would have required it, the scope of the present monograph has been confined to the case of companies.

## PREFACE

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The monograph is not a detailed exposition by precept and example of the accounting practices to be followed in the preparation of the accounts of companies so that they will give a true and fair view. It is an exposition of the philosophy and principles of that formula which should be observed in the development of appropriate accounting practices and the adoption of them in relevant circumstances to meet its objectives. The fact that "a true and fair view" is a philosophical concept and not susceptible to definition by a comprehensive set of detailed rules is, in fact, its most fundamental and characteristic feature.

The views which are expressed are my own. But they are not random or speculative thoughts. They are derived from my experience as a practitioner and my study of the theory, practice and law relating to company accounts. I believe that the explanation which I offer is a sound interpretation of what the law requires in Great Britain; and in principle it should be applicable in those countries which have followed the British style and have adopted the formula of "a true and fair view" as the standard of reporting. I do not know how close my interpretation is to the understanding of those who prepare, audit or use accounts. This is a subject for careful empirical research, which I believe is necessary to establish what the state of knowledge is in this important matter of financial reporting.

I am indebted to the members of the Research Advisory Committee of The Institute of Chartered Accountants of Scotland, to colleagues in public practice and in the University of Glasgow, and to others for helpful comments and suggestions. None of those who were good enough to help me are, of course, responsible for any remaining shortcomings.

David Flint  
University of Glasgow  
April 1982

# *1 The significance of “A True and Fair View”*\*

The fundamental principle of reporting in company accounts is that the primary responsibility rests on the directors to make a full disclosure to enable the company and the directors to be judged as to whether what they have done is acceptable to shareholders, to other relevant interest groups and to society, and to enable these groups to take such decisions about the future as are competent to them. Reporting is a legal duty, although it may also be a social obligation. To discharge that duty the law may specify precisely and in detail what information must be given to constitute full disclosure or may leave it to the directors to interpret appropriately in the circumstances what information is required, in the knowledge that they will be subject to social pressures and legal sanctions if they fail to do so satisfactorily. There is, however, a third alternative. Without relieving directors of their ultimate responsibility, the law may prescribe the general principle to be observed by directors in reporting and then specify particular requirements only in such detail as is necessary to illustrate and support the general principle and to establish the information which is likely to be necessary in the generality of circumstances. This third alternative is the philosophy which has been adopted in British company law, in which giving “a true and fair view” has been prescribed as the overriding standard of reporting.

This philosophy is not without its difficulties, and there are pressures from a number of quarters to abandon it in favour of a wholly prescriptive approach. The flexibility which is its strength is seen by critics as a source of weakness and its most unsatisfactory feature. Meantime, the pressure for change has been resisted, and, although there is increasing specification to cover the generality of circumstances, the final test remains that the directors must consider whether that specification does satisfy the overriding require-

\* For a fuller discussion see David Flint, “The Significance of the Standard ‘True and Fair View’ ”, 1980 Invitation Research Lecture, New Zealand Society of Accountants, Wellington, N.Z.

## THE SIGNIFICANCE OF "A TRUE AND FAIR VIEW"

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ment. Nevertheless, it would be useful to outline briefly the nature of the issue.

Accounting and financial reporting require recognition, measurement and valuation of economic phenomena. The process is subjective and involves assumptions about the future. The relative importance of social, economic and political variables affecting accounting valuations and the significance of accounting information are not constant; and there must always be a greater or lesser degree of uncertainty in respect of the variables affecting financial reporting. It can be argued that such a situation is much too complex for it to be left to the vagaries of individual judgment to decide whether the extent, basis and format of disclosure satisfy the ill-defined criteria of "a true and fair view"; that it is the very uncertainty and complexity of the circumstances which require prescription of the data to bring some certainty to a difficult situation; and that it is unreasonable and impracticable to expect individuals to resolve the difficulties.

The solution according to this approach is for the basis of recognition, measurement and valuation of the economic phenomena and the extent, basis and format of disclosure and presentation to be legislated for in as much detail as foreseen circumstances allow, with minimal scope for individual variation. This has the necessary implication that potential loss of information resulting from a failure to provide for individual situations is compensated for by a quality of certainty about the information which is provided. It has the implication also that this "*certainty*" of knowledge on the part of users about the data which they do have, is preferable to an *opinion* about the relevance of that data and about additional or alternative data appropriate to the particular circumstances.

However, it is because of the inherent uncertainty attaching to the variables, the evolving and changing nature of the social, economic and political context, and the present inadequate state of knowledge of accounting theory and financial reporting that a detailed prescriptive approach must always be to some extent inadequate, invariably out of date as legislation lags behind the need for change, and inappropriate as situations arise which have not been foreseen and provided for. A detailed prescriptive approach must inevitably be an authoritarian, and perhaps arbitrary, imposition of particular solutions, without adequately distinguishing the variety of circumstances which can arise. Such an approach requires also that the legislating body must take a conclusive decision not only about the objectives of accounts and the identity of users but also about the nature, extent and basis of information which they should and may receive. It is because of this uncertainty, evolution, change and inadequacy that, in principle, the concept of giving "a true and fair view" in reporting as an overriding criterion ought potentially to serve better the public interest. Giving "a true and fair view" requires the exercise of skilled judgment in the unique circumstances of each individual case.

## THE SIGNIFICANCE OF "A TRUE AND FAIR VIEW"

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It is understandable that putting responsibility on directors and auditors to consider "a true and fair view" as an independent concept worries some of those concerned with corporate accountability. This apparent "free for all" where every director and auditor can have his personal view of "a true and fair view" seems to them to spell disorder and even reporting chaos. They argue that, if this course is pursued logically to a conclusion, giving paramount status to an individual interpretation of "a true and fair view" in relation to user decision-oriented needs could undermine confidence in the customary financial statements and accounts and lead to their adequacy being challenged. They fear that it gives licence to directors to do what they wish and no protection to the public. These worries are not well founded. There is little risk of a maverick report on some ill-founded, idiosyncratic basis. There are legal, regulatory and professional restraints which preclude violent variations from the norm. What is being sought is a professional opinion. A rigorous self-searching against the criteria of "a true and fair view" is more likely to lead to experimenting with *additional* disclosure and *supplementary* statements than to an abandonment of established practice and disruption of communication.

The effectiveness of the concept of "a true and fair view" in reporting is, however, entirely dependent on the competence, skill, expertise and, especially, the soundness of judgment of directors and auditors. Reliance on interpretation of "a true and fair view" predicates on the part of directors and auditors a capacity to inform themselves, to evaluate, and to exercise judgment on the meaning and significance of those domestic, national and international factors which affect the relevance of information, the criteria of accounting valuations and the expectations of users. It predicates also a capacity to arrive at an opinion on disclosure and presentation of information which satisfies a social perception of what is "true and fair" in relation to that information and the particular situation.

The merit of a reporting philosophy based on the concept of "a true and fair view" is that it recognises that prescription is a means to an end and not an end in itself, and that general prescription is subordinate to particular judgment as to what is necessary in the circumstances to achieve the objectives of full disclosure of relevant information and effective accountability. Far from providing too flexible a framework for the exercise of directors' discretion, this philosophy denies to directors the possibility of using the protection of a narrow legalistic compliance with detailed prescriptive requirements to avoid embarrassing disclosures of necessary information which the prescription has failed to procure. This philosophy imposes, rather, a much more demanding and rigorous obligation, to require directors to consider what information they should disclose to satisfy their legal and social obligations of accountability.

## 2 *The Background*

The concept of “a true and fair view” as the standard of reporting in the profit and loss account and balance sheet of a company was first introduced into law by the amending Companies Act of 1947 and was then incorporated in the consolidating statute, the Companies Act 1948. This followed the recommendation of the Cohen Committee on Company Law Amendment, which had reported in 1945 (Cmnd 6659). The previous requirement was for the balance sheet to give “a true and correct view” of the state of a company’s affairs. This concept had been introduced in the model set of articles included in Table B of the Joint Stock Companies Act 1856, but adoption of these articles was not mandatory. The requirement to give a true and correct view of the state of affairs of a company did not become universal until the introduction of compulsory audit in the Companies Act 1900.

In making their recommendation the Cohen Committee adopted the proposal of The Institute of Chartered Accountants in England and Wales that “true and fair” should be substituted for “true and correct” in regard to the view of the state of affairs given by the balance sheet and also that it should be applied to the profit and loss account, which would for the first time be embraced in the auditors’ report. No reasons were given, however, either in the submission by the Institute or in the recommendation by the Committee, for the replacement of “correct” by “fair”. Reviewing the position in 1962 the Jenkins Company Law Committee (Cmnd 1749) endorsed the terms of the requirement, stating, “the formula ‘true and fair’ seems to us satisfactory as an indication of the required standard”. No change in that formula has been made in any of the Companies Acts of 1967, 1976, 1980 or 1981. Following the entry of the United Kingdom to the European Economic Community, the British representatives were successful in their efforts to have the formula incorporated in the Fourth Directive on Company Accounts and adherence to it is now required in the accounts of specified companies in all the member states.

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### **The formal requirement**

The formal requirement in Great Britain now is that, in respect of all companies subject to the provisions of the Companies Acts 1948 to 1981, the annual accounts prepared by the directors and laid before the company in general meeting shall comply with the requirements of the 1948 Act (as amended) with respect to the form and content of the balance sheet and profit and loss account and any additional information to be provided by way of notes to the accounts; that the balance sheet shall give a true and fair view of the state of affairs of the company as at the end of its financial year; and that the profit and loss account shall give a true and fair view of the profit or loss of the company for the financial year. The Act, however, provides also that the requirement to give a true and fair view shall override all other requirements of the Companies Acts as to the matters to be included in a company's accounts or in notes to those accounts (Companies Act 1948, section 149 and Schedule 8).

Group accounts which are required to be prepared by companies which have subsidiaries — and which normally comprise a consolidated balance sheet and consolidated profit and loss account — must comply similarly with respect to the form and content and additional information. They too are required to give a true and fair view, in this case of the state of affairs and profit or loss of the company and the subsidiaries dealt with by the accounts as a whole, so far as concerns members of the company.

As regards the audit of accounts, the auditors of a company are required to make a report to the members on the accounts examined by them, and on every balance sheet, every profit and loss account and all group accounts, of which a copy is laid before the company in general meeting during their tenure of office. In their report they are required to state whether in their opinion the company's balance sheet and profit and loss account and the group accounts (if any) have been properly prepared in accordance with the provisions of the Companies Acts 1948 to 1981 and, without prejudice to the foregoing, whether in their opinion a true and fair view is given, in the case of the balance sheet, of the state of the company's affairs as at the end of its financial year, in the case of the profit and loss account, of the company's profit or loss for its financial year, and in the case of group accounts, of the state of affairs and profit or loss of the company and its subsidiaries dealt with thereby, so far as concerns members of the company (Companies Act 1967, section 14).

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### **A need for interpretation**

In spite of the continuing adherence of the law to the concept of “a true and fair view” and its central importance as a reporting standard for company accounts, there is no authoritative legal definition or interpretation of its meaning, nor is there a specific accounting practice interpretation, to which an interested person may turn for guidance as to what information must be given in the accounts or how that information should be presented in order to satisfy the requirement. Much of the professional and academic discussion has been critical, not only of the appropriateness of the requirement but also of the adequacy of current accounting practice in meeting any reasonable interpretation of the meaning of the terms in which the requirement is expressed. Criticism and dissatisfaction have been increasingly voiced on the specific issue of the failure of conventional accounting methods to show the impact of inflation on the profit and state of affairs of a company as shown by its accounts, and on the wider question of the limitations of the historical cost method as a frame of reference for financial reporting.

The facts are, however, that for more than thirty years the directors of companies have approved and the auditors have reported on accounts which have been claimed to have given “a true and fair view” as required by law. It is reasonable to assume, therefore, that there must be some general understanding of what is required, although it is not explicitly recorded. Whether that interpretation of the meaning is one which would satisfy either the legal requirement or the public expectation has not been tested in the courts. Accordingly, in view of the fact that there is growing concern as to whether that standard of reporting, as it is being applied, is appropriate for current circumstances, it is important to clarify what it really should mean to those who have to apply it.

### **Accounting and financial reporting**

An understanding of the “view” which is given by company accounts and whether it is “a true and fair” one, requires some knowledge of accounting, of the purposes for which accounts are prepared, and of the objectives which they are intended to fulfil. For the purpose of this monograph a reasonable understanding of accounting practice will be assumed and discussion of the concept of “a true and fair view” will proceed on that basis. Readers who wish to refresh their understanding are recommended to refer to the first chapter of the first monograph in this series, “The Audit Report”,<sup>1</sup> in which a brief

<sup>1</sup> The Audit Report, J.C. Shaw, ICAS Gee and Co (Publishers) Ltd, 1980

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outline of the salient features of the accounting process is given. The most important factors in the preparation of accounts, which readers should bear in mind, are that they do require the use of opinions and the exercise of judgment and that they do depend on assumptions about the course of future events.

Although great emphasis is placed on objectivity and freedom from bias in the accounting process and in reporting, the accounts are, in character, essentially subjective. Accounting and financial reporting do not have the precision and accuracy of scientific analysis. The information content of financial statements is an expression of opinion, based on knowledge and experience. The established and well understood processes and procedures of accounting and financial reporting provide a framework for the responsible expression of opinion, and the criteria by which financial reports may be judged must recognise this essential characteristic. In some cases the degree of tolerance for difference of opinion may not be great, but the nature of financial reporting is such that the view which may be given at any point of time in a continuing business enterprise is not a unique one. Acceptance of this premise is an essential starting point for consideration of the meaning of "a true and fair view".

## 3 *Company Accounts*

### **The responsibility of directors**

The formal legal position is that it is the directors of a company who have the primary responsibility for the adequacy of the accounting records and for the information which is disclosed in and the view which is given by the annual accounts. A company is explicitly required to keep accounting records which are sufficient to show and explain the company's transactions, and which, *inter alia*, are such as to enable the directors to ensure that any balance sheet and profit and loss account prepared by them give a true and fair view respectively of the company's state of affairs and profit or loss (Companies Act 1976, section 12). If a company fails to do this, a director must be able to show that he acted honestly and that the default was excusable. It is also a specific legal requirement that it is the directors of a company who shall prepare, lay before the company in general meeting and (with optional modifications for small and medium-sized companies (Companies Act 1981, sections 5 to 10)) deliver to the Registrar of Companies the prescribed profit and loss account and balance sheet (Companies Act 1976, section 1).

The directors' responsibility for accounts does not, however, depend wholly on the Companies Acts. There are two general principles which are important to the operational interpretation of the reporting standard. Firstly, in their capacity as fiduciary agents the directors have a general obligation to account, to which, Gower (in the 3rd Edition)<sup>1</sup> suggests, "the Act probably adds little or nothing". Secondly, the general philosophy of the law for the protection of shareholders is one of full and frank disclosure. The Companies Acts give statutory authority and explicit expression to these general principles but they do not modify the general objective. In a recent review of the position, the Sandilands Committee<sup>2</sup> stated that it was a "traditional

<sup>1</sup> The Principles of Modern Company Law, L.C.B. Gower, 3rd Edition, Stevens & Sons, 1969, p. 456.

<sup>2</sup> Report of the Inflation Accounting Committee, 1975, Cmnd 6225.

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tenet of accounting that the main objective of published financial statements is to enable the directors to give an account of their stewardship of the shareholders' funds to the shareholders". In relation to the annual accounts this is where the law stands today.

Directors have, of course, obligations to other groups. Their duty of accountability and their responsibility to provide information are wider than the well-understood ones to shareholders. However, the question which directors are obliged to consider is: what is the information which they, as fiduciary agents who are accountable, must disclose to enable shareholders to be informed about the company. It is against this objective in the first instance that directors have to consider, in the uncertainties of a continuing business, what information it is necessary to include in the annual accounts, at a particular time and in the relevant circumstances of that time, so that they will give a true and fair view of the state of affairs and profit or loss.

### **The accounts**

The basic requirements of the Companies Acts with respect to the form and content of a company's accounts prescribe the items which must be shown, the order of the items, and the headings under which the items must appear. There are also stipulated certain "accounting principles" and "accounting rules", and provision is made for disclosure of specified information. This provides the framework within which it is expected that the company should report. The objectives of the accounts are to enable shareholders and other users of the accounts to form an opinion and to take decisions about the honesty and regularity of the conduct of the directors and about their economic and social performance.

### **State of affairs**

The Companies Acts require that the balance sheet of a company shall give a true and fair view of the state of affairs of the company as at the end of its financial year. The expression "the state of affairs" of a company, however, has not been the subject of definition or interpretation. Its meaning must be deduced, therefore, from what is implied by the prescriptive requirements and from what is necessary to satisfy the objectives of the accounts and the general duty of accountability of directors.

Users of accounts need to be informed about the nature and amount of the company's assets and liabilities and to be able to form an opinion on liquidity, solvency, fixed asset investment, working capital, financial position

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and general financial strength. These are aspects of the “state of affairs” which the balance sheet is expected to disclose. The balance sheet is not intended to give the directors’ valuation or any other valuation of the undertaking; but, in conjunction with the profit and loss account and additional information which the users derive from other sources, it should enable any users who wish to do so to form their own opinion about the value to them of an investment in the company. The concern of users is for the future as well as for the past. The “state of affairs” must, therefore, be interpreted in that context, providing information to enable expectations about the future to be formed as well as opinions about the past. It is a basic principle underlying the preparation of the accounts that it is to be presumed that the company is carrying on business as a going concern. Accordingly, unless this basic presumption is unsupportable, it is the state of affairs on the basis that the business of the company is continuing of which a view is required to be given. If the basic presumption is invalid because the business cannot or will not continue, then the relevant state of affairs would be the one appropriate to the circumstances. For example, if cessation of business and winding up of the company is the prospect then this will determine the basis on which the state of affairs is ascertained.

The kind of information which is necessary to enable an opinion to be formed about performance and prospect, and in particular about liquidity, solvency, financial position and so on, as outlined above, is a matter of professional judgment. A balance must be struck between the minimum essential for any rational opinion to be formed and the extensive list which a user might have if no costs were involved. Needs and expectations are changing because the economic and social contexts are changing. The greatest controversies are about the extent to which value changes should be reported and about which values are relevant to the issues which have been outlined. There is also a growing awareness of the relevance of “social responsibility” costs and “research” costs in consideration of a wider interpretation of a “state of affairs” as a basis of future expectations. The important point for this discussion is that the criteria for determining whether “a true and fair view” of the state of affairs is given require that the most comprehensive view is taken of the relevant issues to be examined.

### **Profit**

The Companies Acts require that the profit and loss account of a company shall give a true and fair view of the profit or loss of the company for its financial year. There is no formal definition of profit but, as in the case of the balance sheet, there are laid down a number of “accounting principles”

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and “accounting rules”. In particular, it is provided that only profits realised at the balance sheet date shall be included in the profit and loss account; and “realised profits” are defined as those which fall to be so treated “in accordance with principles generally accepted with respect to determination for accounting purposes of realised profits at the time when those accounts are prepared”. The overriding requirement, however, is to give a true and fair view, and departure from any of the principles or requirements may be made if necessary to do so.

It is important to appreciate, therefore, that there are a number of bases on which profit may be measured and this is recognised by the Companies Acts in providing for the “historical cost accounting rules” and the “alternative accounting rules”.

In introduction to their discussion of concepts of profit the Sandilands Committee<sup>3</sup> stated that “no clear cut distinction exists between those gains that may be regarded as profit and those that may not. ‘Profit for the year’ is a practical business concept used as a guide for prudent decision making by companies.” The Committee then proceeded to discuss five different concepts, concluding that all were right within their own assumptions and that “no single concept is likely to be universally ‘correct’. Some will be more useful than others in certain circumstances, and it is very unlikely that one concept will be appropriate in all circumstances . . . choice of a profit is a practical business issue that cannot be solved independently of the needs of users of accounts”.

Not all theorists would accept the validity of all the various concepts but no one would dispute the primary importance of “the needs of users of accounts”. Differences of opinion exist on concepts of capital and of requirements of capital maintenance in measuring profit. The interest of users in performance and prospect requires that they be informed on the extent to which the capital of the business has been maintained, the adequacy of the profit for payment of interest and dividends, and the vulnerability of profit to changes in circumstances. A view of the profit or loss is not given by focus on one figure alone, and “a true and fair view” can only be given if sufficient information is disclosed to enable the users to be fully informed on the “quality” of the profit which the company has achieved. Users of the accounts require to have the relevant information to enable them to form their opinion on the durability of the profit and its sensitivity to changes in circumstances affecting the business of the company. It is for this reason – apart from any others – that information must be given on turnover and profit by classes of business, and on regional and international distribution of turnover, such as may be judged to be necessary to give a true and fair

<sup>3</sup> Report of the Inflation Accounting Committee, 1975, Cmnd 6225.

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view of the profit in relation to the needs of the user.

These are the issues which must be foremost among the criteria for determination of whether “a true and fair view” of the profit or loss is given.

### Group accounts

Where at the end of its financial year a company has subsidiaries, group accounts require to be prepared dealing with the state of affairs and profit or loss of the company and the subsidiaries. These are normally in the form of a consolidated balance sheet and a consolidated profit and loss account.

These consolidated accounts are required to comply so far as practicable with the requirements of the Companies Acts as if they were the accounts of an actual company. Although it is specifically provided that the consolidated accounts shall combine the information in the separate accounts of the holding company and the subsidiaries, it is also provided that this will be done with such adjustments as the directors of the holding company think necessary. This is a clear recognition that the preparation of consolidated accounts requires something more than a simple aggregation of the figures in the accounts of the constituent companies. This is understandable since it is required that the consolidated accounts shall give a true and fair view of the state of affairs and profit or loss of the company and the subsidiaries *as a whole*. For the purpose of considering “a true and fair view” the directors must consider the group as a whole and the group accounts as the accounts of an actual company. It is for this reason that inter-company adjustments must be made (for example, eliminating profit on inter-company trading transactions), that accounting policies must be consistent throughout the group, and that materiality must be considered on a group basis. The form and content of the consolidated accounts, the basis of presentation and the criteria of disclosure must be considered from the standpoint of forming a view of the state of affairs and profit or loss of the group as a whole. To enable such a view to be given may well require additional information or adjustment to the information in the separate accounts of the companies in the group, particularly with the diversity of conditions in groups with foreign subsidiaries.

Finally, it should be noted that the view which is required to be given by the consolidated accounts is qualified to the extent that it is “a true and fair view of the state of affairs and profit or loss of the company and its subsidiaries, *so far as concerns members of the company*” (emphasis added). This gives notice to the interest groups other than shareholders of the holding company that the technique of consolidation does not necessarily result in

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accounts which give a view which is most useful to them, particularly if their concern is with the affairs of a constituent company.

### A view

Preparation of accounts giving a view of the state of affairs of a company as at the end of a financial year and of the profit or loss for a financial year which discharge the directors' obligation to account with full and frank disclosure, as discussed above, is a task requiring professional skill. It is not mechanistic in character, involving no more than the execution of a series of established and well known, although sometimes complex, procedures. It is not simply a systematic process by which the figures of transactions which have been incorporated into the accounting records during the financial year are analysed, summarised and arranged to produce two (or more) abbreviated statements encapsulating the activity of the year and the position at its close.

A business enterprise is engaged in economic activity using human, material and financial resources. The economic activity over a period and the economic position at a point in time are the reality. The purpose of the accounts is to communicate to those who read them the essential features of that reality. Ascertainment of profit and state of affairs involves measurement and valuation, and these require the exercise of judgment, whether it is the value of buildings, plant, stock, debtors, investments or any other valuable right which is involved. Even if the basis of valuation is agreed, there can be legitimate room for difference of opinion on value on that agreed basis. The difference of opinion may be, for example, on the prospective use and economic life of plant, the marketability or realisability of stock or the collectability of debts. Critical to the basis of valuation for determining profit or state of affairs is whether the enterprise should be considered to be a going concern; and whether, for example, the balance sheet should purport to represent values in present use or values on realisation.

More fundamental questions are: from which users' standpoint have the accounts to be considered; what level of understanding is to be assumed on the part of those who have to form opinions and take decisions; how much information and what form of presentation are necessary to enable the users to form the opinions and to take the decisions which are competent to them; and what basis of profit ascertainment or of assessment of state of affairs will satisfy their expectations?

The ASC's Discussion Paper, *The Corporate Report*<sup>4</sup>, suggested that

<sup>4</sup> *The Corporate Report, Discussion Paper, The Accounting Standards Committee, 1975.*

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“the fundamental objective of corporate reports is to communicate economic measurements of and information about the resources and performance of the reporting entity useful to those having reasonable rights to such information” and it identified seven groups\* whom it was considered could claim to be included. The requirements of the Companies Acts are, however, for the accounts to be laid before the company in general meeting and to be sent to members, debenture holders and certain other persons. While it is generally held that it is the interests of the members which must be considered in the preparation of the accounts, since the accounts are prepared primarily as a report to them, it is also well understood that they will be used by other groups. Although, in the provisions of the Companies Acts, there is no explicit recognition of the change in public expectations which has taken place over time, the duty of accountability of companies and their directors in social terms does now undoubtedly embrace a wider spectrum than shareholders. In the preparation of the accounts the rights and the needs of shareholders certainly rank first in importance, but it can be too readily assumed that the adequacy of the accounts is to be considered only by reference to their standpoint, their criteria and their expectations. Other interest groups must also be considered.

Nevertheless, the primary duty of accountability to shareholders requires that the view which is given is one which satisfies their rights and is useful to them in relation to their needs. It is important that other groups of users should understand this. In accordance with evolving social concepts of accountability, accounts may develop to give information of particular interest to other groups, but, as the law stands at present, the foundation or starting point is the package of information which serves the shareholders' interest.

Although the accounts are prepared to give a view which satisfies the rights and needs of shareholders, it does not follow that they must be wholly comprehensible to every individual shareholder. It cannot seriously be represented that the accounts of complex modern business enterprises should be comprehensible to the “reasonable man”, caricatured by legal writers as the man on the Clapham omnibus\*\*. What is important is that there is available in the accounts all the information which is necessary to enable a person, who is competent to use it, to come to the right conclusion about what the accounts purport to represent. Some part of the accounts will be

\* Equity investors; loan creditors; employees; analysts/advisers; customers, suppliers, competitors; the government; the public.

\*\* This does not conflict with the view, which has some support, that a less complex financial statement should also be available to inform interested persons generally about the company, making clear by explicit disclaimer that it is incomplete.

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understandable to anyone with minimal knowledge of accounting, finance and business affairs. The extent of understanding will vary with the level of knowledge. However, it would be wrong to pretend that the whole meaning and import of the "true and fair view" which is given by accounts can be understood by a person other than one with a substantial knowledge of accounting practice. This is the level of understanding which is assumed by the concept of "a true and fair view".

## 4 *A True and Fair View — Meaning and Criteria*

Although the requirement for annual accounts of a company to give a true and fair view was introduced by the amending Companies Act of 1947, the terms “true” and “fair” were not new in the law relating to company accounts. The Joint Stock Companies Act of 1844 required companies to present “a *full and fair* balance sheet”, the Companies Clauses Act of 1845 required the preparation of an “*exact* balance sheet” showing “a *true* statement” of the assets and liabilities, and the Companies Act of 1879 referred to “a *full and fair* balance sheet properly drawn up, so as to exhibit a *true and correct* view of the state of the company’s affairs”. Accounting and financial reporting were almost completely undeveloped in 1844 and there was no accounting theory or philosophy on which the legislators could have drawn in devising criteria for the standards of accounting and reporting. The terms of reporting used in the legislation clearly have a jurisprudential quality. They were perceived by jurists as indicative of the quality of accounts which would satisfy the public understanding of the duty of accountability which the law should impose on companies and their directors.

There have been more recently a number of attempts to interpret “true” and “fair” separately and literally. These, however, have been mainly concerned with discussing which “facts” represent the “truth” about a company’s profit, or assets, or liabilities, whether there is such a truth, and which “facts” have to be disclosed to enable the view which is given to be “fair”. The discussion has been about the difficulties of implementing such a requirement, and, it is even suggested, about the impossibility of doing so. It is not sufficient to say that true means “in accordance with the accounting records (the books of account)”, since it is settled law that in preparing the accounts the directors must look beyond the books to consider whether they do show the true financial position. And it is an over-simplification to say that true means “in accordance with the facts” since there are a number of alternative sets of facts, each of which shows a financial position. The dilemma is: which of these is the one required by law; or, alternatively, does the law require that

all of them should be given? Similarly, it does not advance understanding to equate “fair” with, for example, “just”, “unbiased” or “not misleading”. These issues are not in dispute. What the law requires in relation to disclosing the true financial position of a company is that the accounts should not be misleading or fraudulent.

The use of “true” and “fair” in the formula for the reporting standard of company accounts is not a distortion of their ordinary meaning as has been sometimes suggested. The position is rather that the significance of their ordinary meaning in this context can only be fully appreciated with a knowledge of the principles and prescriptions of the law and the complexity of practice in relation to company accounts.

### Prescriptive requirements

Successive statutes have extended the prescriptive requirements with respect to the form and the content of the balance sheet, profit and loss account and notes comprised in the accounts of a company, but the Companies Act 1981 has gone further than any previous statute in prescribing principles\* to be followed in determining the amounts to be included in respect of items shown in the accounts. These principles remain subordinate to the overriding requirement for the accounts to give a true and fair view, so that, if it appears to the directors that there are special reasons for departing from any of the principles, they may do so, although they are required to give the reasons for and the effect of the departure. However, the effect of these prescribed principles does not represent any major innovation. They mainly refer to normal accounting practice which has already been formulated by the professional accountancy societies in a Statement of Standard Accounting Practice (SSAP 2) dealing with the fundamental accounting concepts of “going concern”, “accruals”, “consistency” and “prudence”.

The prescriptive requirements with respect to form and content of the balance sheet, profit and loss account and notes are contained in Schedule 8 to the Companies Act 1948. This was substantially amended by the Companies Act 1981, which gave legislative effect in Great Britain to the provisions of the Fourth Directive on Company Law of the EEC. Rules for the determination of amounts to be included in the accounts are also laid down. These may be either “the historical cost accounting rules” or “the alternative accounting rules”. The historical cost accounting rules specify the historical cost accounting system which is currently in use and for which the basis figures are purchase price or production cost. The alternative accounting

\* See Appendix I.

rules allow the adoption in the accounts of current values for assets, generally arrived at as a derivative of current cost, but require the comparable amounts determined according to the historical cost accounting rules (or the differences between the amounts determined according to the two sets of rules) also to be shown.

### **Normal accounting practice**

In reviewing the position in 1962 the Jenkins Committee concluded that the general scheme of the Act was the right one, “namely to indicate in general terms the objectives and the standard of disclosure required and also to prescribe certain specific information that must be given”. “The formula ‘true and fair’”, they stated, “seems to us satisfactory as an indication of the required standard, while it makes for certainty to prescribe certain specific information which the law regards as the minimum necessary for the purpose of attaining that standard”. They then went on to emphasise the overriding requirement, saying, “we doubt if it is always appreciated that accounts which comply strictly with the requirements of the Eighth Schedule may still fail to give the true and fair view required by the Act, although we think this is the effect of section 149(3) [Companies Act 1948 before amendment], which provides that the duty to give the detailed information required by the Eighth Schedule is without prejudice to the general duty to give a true and fair view”.

It seems clear, therefore, that the legislature gives authority to the proposition that there are criteria for judging “a true and fair view”, although it has not attempted to be specific about what these are. The meaning of this formula of “true and fair” has never been put to direct judicial test, but the legal writers support the view that adherence to normal accounting practice as to the basis of accounting and as to the degree of disclosure would be prima facie evidence of giving a true and fair view.

What is “normal accounting practice” has generally been argued to be a question of fact about which evidence could be produced in particular circumstances. The Companies Act 1981 has for the first time in British company law, in a specified and limited context, endorsed this proposition in introducing the concept of “generally accepted principles”. It is declared in the Act that, for the avoidance of doubt, “references to realised profits, in relation to a company’s accounts, are references to such profits of the company as fall to be treated as realised profits for the purposes of those accounts in accordance with principles generally accepted with respect to the determination for accounting purposes of realised profits at the time when those accounts are prepared”.

In recent years, a more positive approach to the definition of normal accounting practice has been attempted by the professional accountancy societies by the formulation and publication of Statements of Standard Accounting Practice (SSAPs), but the concept of “generally accepted accounting principles” (GAAPs), which has been current in USA since the 1930s, has not been in general usage. Subject to interpretation of what might be thought to be “principles” of accounting and what constitutes “general acceptance”, the new enactment appears to strengthen the authority of the general legal doctrine of adherence to normal accounting practice.

In 1958, in one of a series of “Recommendations on Accounting Principles”, The Institute of Chartered Accountants in England and Wales did make reference to “accounting principles” in its interpretation of “a true and fair view”. “A true and fair view” in the balance sheet, it was stated, “implies appropriate classification and grouping of the items” and “also implies the consistent application of generally accepted principles”. Dealing with the profit and loss account, it was stated, “provided that the account . . . is the result of consistent application of recognised accounting principles it can properly be stated to be true and fair”. However, the “principles” which were promulgated at that time were recommendations, and they were persuasive in their force rather than definitive. It was accepted that the exercise of judgment could result in some variation in measurement and valuation and, accordingly, in the timing of recognition and reporting of profit and in the presentation of the state of affairs.

Experience in the years which followed showed that the extent of the variation which prevailed in practice was no longer acceptable and this led to the establishment by the professional accountancy societies of the Accounting Standards Committee (ASC)\* at the end of 1969. The objective was to narrow the areas of difference and variety in accounting practice by publishing authoritative statements on best accounting practice which would, wherever possible, be definitive. It was, however, stated that it was recognised that the complexity and diversity of business activities gave rise to a variety of accounting practices justifiably designed for and acceptable in particular circumstances and that rigid uniformity was impracticable.

### Statements of Standard Accounting Practice

As a result of the work of the ASC a number of Statements of Standard Accounting Practice\*\* have been approved by and published with the authority

\* Initially the Accounting Standards Steering Committee (ASSC) 1969-1976.

\*\* See Appendix II.

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of the professional accountancy societies\* to give a more definitive approach to the concept of what gives a true and fair view. In the Explanatory Foreword to the SSAPs, first issued in 1971, the continuing need for the exercise of judgment is, however, recognised. “Accounting Standards”, it is stated, “are not intended to be a comprehensive code of rigid rules. It would be impracticable to establish a code sufficiently elaborate to cater for all business situations and circumstances and every exceptional or marginal case, nor could any code of rules provide in advance for innovations in business and financial practice. Moreover, it must be recognised that there may be situations in which for justifiable reasons accounting standards are not strictly applicable. . . . (It is) important to have regard to the spirit of accounting standards as well as to their precise terms and to bear in mind the overriding requirement to give a true and fair view.”

It must be recognised, therefore, that it is acknowledged by the professional accountancy societies that, while SSAPs must be regarded as highly persuasive in matters of accounting practice in accounts intended to give a true and fair view, adherence to the Standards is a means to an end and not the end itself. The appropriateness of any Standard to the particular circumstances, or the result of application of any Standard, must be considered against the criteria of “a true and fair view”. While the incorporation in the Companies Act 1981 of a reference to “principles generally accepted” with respect to one particular item may be regarded as supportive of a more general endorsement of the persuasive force of SSAPs, it would be going too far to assume that it does more. The test in law which will be applied, if this is necessary, is not whether the Standards have been adhered to but whether the accounts give “a true and fair view”. Nevertheless, adherence to normal accounting practice as to the basis of accounting and the degree of disclosure, of which SSAPs should be evidence, would be prima facie evidence of giving “a true and fair view”. The distinction is vitally important because it leads back to the need to consider what are the criteria of “a true and fair view”, which is the test in law and by reference to which the consequences of the application of the Standards, and ultimately the views given by the profit and loss account and balance sheet, are to be judged.

\* The Institute of Chartered Accountants in England and Wales  
The Institute of Chartered Accountants of Scotland  
The Institute of Chartered Accountants in Ireland  
The Association of Certified Accountants  
The Institute of Cost and Management Accountants  
The Chartered Institute of Public Finance and Accountancy.

### Criteria

As far as the law is concerned there is no universal set of detailed rules for the preparation of accounts which are required to give a true and fair view which are applicable to all circumstances. A choice must be made from the alternatives, according to which will satisfy the overriding requirement. These are:

- (1) to prepare accounts, in accordance with normal accounting practice, on the basis of the historical cost accounting system, and in compliance with the requirements of the Companies Acts as to form and content and additional information by way of notes, and with the provision of such further information, if any, as is necessary to give a true and fair view;
- (2) to prepare accounts, in accordance with normal accounting practice, on the basis of a current value accounting system (which requires comparable historical cost based data), and in compliance with the requirements of the Companies Acts as to form and content and additional information by way of notes, and with the provision of such further information, if any, as is necessary to give a true and fair view;
- (3) if special circumstances require it so that a true and fair view may be given, to prepare accounts which depart from compliance with the requirements of the Companies Acts as to form and content and additional information; or
- (4) if it appears to the directors that there are special reasons for so doing, to prepare accounts on a basis which involves departure from the accounting principles laid down in the Companies Acts.

The first accounting principle laid down in the Companies Act 1981 is that the company shall be presumed to be carrying on business as a going concern. In preparing accounts the directors require to test whether that is a tenable presumption. If it is not, this would constitute a special reason for departing from the principle and adopting a different basis which would satisfy the directors' responsibility to prepare accounts which give a true and fair view of the state of affairs or financial position of the company in those circumstances.

When the directors are satisfied that the company is a going concern the choice which has to be made is whether to follow the historical cost accounting rules or the alternative accounting rules, with or without additional information and with or without variation, or whether there are special reasons for adopting a more radical departure from the norm. The accounting principles, form and content as laid down in the Companies Acts, together

with the definitive guidance on normal accounting practice given in Statements of Standard Accounting Practice, are highly persuasive as directions on how to prepare accounts but they are not conclusive. The method adopted must produce a result which satisfies the criteria of giving a true and fair view. There are no definitive rules for this overriding requirement. Whether that view has been given requires knowledge, skill and the exercise of judgment.

However, while the concept of “a true and fair view” is that it is the expression of an opinion requiring knowledge and skill and the exercise of judgment, it does not sanction a reporting “free for all”. It must be an expression of opinion within an established, credible frame of reference in order to achieve effective communication. It must be an opinion arrived at on a rational and supportable basis – both theoretically and pragmatically – and it requires to be capable of being substantiated by the directors to the auditors, who have the responsibility to consider independently on the evidence whether the accounts prepared by the directors do indeed give, by reference to known criteria, a true and fair view (see Chapter 5).

Historically the simple fiduciary responsibility of directors was perhaps the most important one, and, although much more is now sought from accounts, this fairly elementary matter should not be overlooked. Shareholders still want to be able to verify that their funds have been fully accounted for and that no illegal activities have taken place. The early expectation of company accounts was probably no greater than this, and it is illustrative of the social and cultural dependence of financial reporting that, with little change in the legal formula, public expectations have evolved continuously since 1844 and have done so particularly rapidly in the last 50 years. Views on what financial information is significant and what should be disclosed are influenced by a number of different factors. Social attitudes and values, political philosophy, cultural standards and traditions, the institutional and legal framework, and beliefs about the objectives and responsibilities of corporate enterprise, as well as attitudes to corporate accountability, all have a bearing on the changing expectations of company accounts.

The early notion of accountability as expressed in honesty and regularity in performance and reporting has been expanded to include the quality of performance, with some reference to economic efficiency and profitability. In addition, the accountability of corporate business enterprise is now fairly generally acknowledged to embrace social accountability, involving, among other matters, questions of employment, conditions of work, quality of products, environmental and ecological factors, conservation, prevention of pollution, and proscription of discrimination. All of these have financial consequences and implications affecting current results and future prospects. In presenting the state of affairs of a company the extent and nature of

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disclosure about any of these require to be taken into account in considering what is a true and fair view.

Although the prescriptive provisions of the law have progressively become more comprehensive, which is consistent with the view of the Jenkins Committee that, “it makes for certainty to prescribe certain specific information which the law regards as the minimum necessary for the purpose of attaining that standard” (*ie*, a true and fair view), the practice of reporting in respect of form and content has invariably moved ahead of the prescriptive law. It was recognised by the Jenkins Committee that it should do so, that it was impossible to devise a list of specific requirements to meet all circumstances and that “it is primarily to the initiative of the professional associations that we must look if the general principles of the Act are to be effectively applied in practice”. The philosophy of the legislation is to lay down the principle – “a true and fair view” – to prescribe certain specific minimum information and to leave it to practice to evolve to meet the changing needs of a changing society. In that context what constitutes a true and fair view of profit or loss and of state of affairs has to be judged, not by reference to the limited capacity for understanding of many individual shareholders, but rather by reference to the public expectation for the fullest information to demonstrate accountability, and to enable performance, position and prospects to be judged and assessed by those who are competent to use the information.

Particularly for listed companies, public boards and similar organisations, accountability can only be secured and monitored on the basis of full disclosure of relevant information.\* Whatever view may be taken of modern market theory there is no doubt that a fair price for securities traded on the Stock Exchange is dependent on the public availability of all known relevant information. Not all the information which is necessary to arrive at a price for a company’s securities can be contained in the annual accounts. The price varies from day to day, is affected by commercial and financial events between accounting dates and is influenced by factors other than financial data. Nevertheless, the annual accounts are important as a prime source of information on which investment decisions are taken and on which the value of securities is agreed between buyers and sellers. The view which is given of profit or loss and state of affairs, to the extent that this can be given in annual accounts, must be true and fair in relation to the interests of these parties. This means not only that the information has to be adequate for the needs of any one party but also that it has to be even-handed as between parties.

\* For further discussion see S.M. Keane, “The Efficient Market Hypothesis and the implications for financial reporting”, a monograph of The Institute of Chartered Accountants of Scotland, Gee & Co (Publishers) Ltd, 1980.

In the case of companies the securities of which are not the subject of Stock Exchange transactions, information is not price sensitive in the sense that its disclosure will have an immediate effect on price. Transactions in securities are infrequent and special investigation can be made in the case of each transaction. Nevertheless, information on “economic” stewardship is important to the users of the accounts of these companies as much as information on “custodial” stewardship, and this must be recognised in reporting the profit or loss and state of affairs.

### **Inflation accounting**

Accounts may be prepared in accordance with the historical cost accounting rules but directors require to consider whether any additional information is necessary or whether any departure from the rules is necessary in order to give a true and fair view. Similarly, accounts may be prepared in accordance with the alternative accounting rules using current values, subject to the same provisos.

There has been, over a long period, an extensive debate on the relevance and appropriateness of the historical cost system of accounting as a credible frame of reference for financial reporting by companies, particularly during periods of a high rate of inflation. The Sandilands Committee (1975) concluded that “To prepare annual company accounts on a historic cost basis, during a period of rapidly increasing prices, reduces them to a low level of usefulness. . . . While such information remains useful for some purposes, historic cost accounts fail to meet the main requirements for information of users of accounts”; and subsequent events and informed debate are very persuasive in support of that conclusion. This is not the place to explore all the merits and demerits of the conflicting views. There is no unanimity as to what system of accounting based on value rather than cost would be most useful.

It does seem clear, however, that it would only be in exceptional circumstances that amounts included in accounts determined in accordance with the historical cost accounting rules could on their own, without additions and/or departures, give a true and fair view of a company’s profit or loss and state of affairs; or that accounts prepared on such a basis could satisfy the duty of full and frank disclosure, present the true financial position of a company or meet the public expectation in relation to a company’s accounts. The position is not resolved by going over completely to one of the systems of value accounting, because the historical cost based information is not yet rejected as completely irrelevant. This is recognised in the Companies Act 1981, which requires historical cost information additionally when current values are used.

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The Statement issued by the professional accountancy societies on this matter (SSAP 16)\* is more specific in its requirements but is limited in its application to listed and larger companies. It requires that annual financial statements intended to give a true and fair view of the financial position and profit or loss should include, in addition to historical cost accounts or historical cost information, current cost accounts which should contain a profit and loss account and balance sheet, together with explanatory notes. The Standard permits either the historical cost accounts or the current cost accounts as the main accounts, and specifies the supplementary information in each case.

The significance of this Standard is that it gives a definitive statement of how historical cost information and current cost information should be combined in the accounts in order to give a true and fair view. The Standard does not and cannot relieve directors of their responsibility to consider whether, in their opinion, in the particular circumstances of the company, that result is achieved; although a departure from Standards is only envisaged in situations which are exceptional or marginal, or where application of the Standards would be impracticable, inappropriate or misleading, or where innovation in practice is justified.

The fact that the Standard (SSAP 16) is applicable only to listed and larger companies does not relieve directors of other companies of their responsibility to consider if any, and on what basis, current value information should be given in the accounts. As already indicated, it would only be in exceptional circumstances that amounts included in accounts, determined in accordance with historical cost accounting rules, could on their own, without additions and/or departures, give a true and fair view of a company's profit or loss and state of affairs, present the true financial position of a company or meet the public expectation in relation to accounts. Circumstances may change, but in present circumstances and with current expectations, in a normal case, "a true and fair view" can be neither given nor obtained without some information on a current value basis appropriate to the company's business.\*\*

\* See Appendix III.

\*\* It should be noted that at the present time the official guidance from the professional accountancy societies does not accord with this view. For further discussion see David Flint, "True and Fair and ED24: Directors' and Auditor's Dilemma", *The Accountant's Magazine*, October 1979, pp. 417-419.

### **Directors' budgets and forecasts**

There is, of course, a great deal of pressure for disclosure, with the accounts, of directors' budgets, forecasts and strategic plans – as part of the “corporate report” – on the grounds that this information is essential for an evaluation of direction and management, for investment decision (buy, hold or sell), and for establishing a fair price for company securities in the market. Directors do respond to this pressure to a greater or lesser degree and with more or less formality, most generally by commentary in the Chairman's Statement. The Companies Act 1981 has made a first step towards formalising the position by requiring that the directors' report shall contain an indication of likely future developments in the business of the company. With this exception, there is no obligation on directors to give future-oriented information in the annual accounts, which in form and content are based on past transactions. Directors must, however, be sensitive to the evolving public expectation of such accounts, and the professional societies must be continually conscious of the reliance, which Jenkins recognised, that the legal philosophy places on their exercise of initiative.

### **Statement of source and application of funds**

Among the additional information which must be considered for inclusion in the annual accounts are particulars of the movements of funds and/or cash as between the beginning and end of the period to which the accounts relate. There is no legislative provision or other legal guidance on this matter but the professional accountancy societies have issued a Statement (SSAP 10)\* requiring enterprises with turnover or gross income of not less than £25,000 per annum to include a statement of source and application of funds in accounts which are intended to give a true and fair view of financial position and profit or loss. It is believed that it is necessary for a proper appreciation of a company's financial position to have the information which is included in such a statement (sometimes described as a Statement of Change in Financial Position). Accordingly, the objectives of the annual accounts as already set out above will, in the normal case, not be able to be met without this information, determined and presented in a form appropriate to the circumstances of the company.

\* See Appendix IV.

### Interpretation of accountability

The importance of the basis of measurement and valuation for determination of profit and state of affairs, which is the subject of present controversy, should not be allowed to obscure the fact that discharge of the directors' duty of accountability requires disclosure of information on more than profit and asset values. "True and fair" has a jurisprudential quality; it has also to be interpreted in a social context of accountability. There is a social dimension to directors' "performance" and to a company's "state of affairs" on which shareholders – apart from others – require information to enable them to judge; and there are pressures from a number of quarters for more information on company affairs. Not all demands can or should be met, and there are inevitable economic and practical constraints on what can and should be provided. The cost-benefit relationship of additional information is always a factor, although the issue is complex. The obligations of disclosure are, however, changing and evolving.

At least one writer has argued that it is not possible in a single financial statement to disclose the amount and type of information necessary to show a true and fair view of the state of affairs of a company in an ideal or general sense of the words.\* That may be an extreme view. There is, however, information in controversial areas, such as research and development costs, energy usage costs, pollution costs and others, particularly in relation to social accountability, which is highly relevant in current circumstances to the decisions of shareholders and the other relevant interest groups but which would not have been considered a relatively few years ago. Without this additional information appropriate to the circumstances of the company and the evolving public expectation, the view of the profit or loss and state of affairs cannot satisfy the test of "fair".

### Summary

Prescription by legislative requirements and professional statements of standards of practice are necessary in the interests of good order and effective communication. If these are soundly based and well conceived they should be widely applicable. But the requirement to give "a true and fair view" is a standard of a higher order. Whatever may be the extent of prescription, an overriding requirement to give "a true and fair view" is, at the lowest level of its utility, a safety valve protecting users from bias, inadequacy

\* T.R. Johnston, *Is the Standard "True and Fair View of the State of Affairs" Attainable in a Balance Sheet?*, Victoria University of Wellington, 1966.

or deficiency in the rules; a fail-safe device for the unavoidable shortcomings of prescription. However, its greater utility is in establishing an enduring conceptual standard for disclosure in accounting and reporting to ensure that there is always relevant disclosure – where necessary beyond the prescription – based on independent professional judgment. It has a social quality expressing the standard of accountability which society sets in company affairs in the context of a societal perception of truth and fairness, which is ultimately a matter of ethics or morality.

Accordingly, accounts which are required to give a true and fair view should comply with specific statutory requirements of disclosure and presentation, and disclose the accounting policies and bases which have been adopted; they should ordinarily be prepared in accordance with normal accounting practice and in compliance with Statements of Standard Accounting Practice, recognising, however, that these are a means to an end and not the end itself. They should be prepared so as to satisfy the professional technical information requirements of what is necessary as a basis of opinion and decision on the part of those who may legitimately expect their needs to be met. They should meet both the general legal requirement for protection of shareholders of full and frank disclosure of information on matters on which they ought to be informed in relation to the company's affairs, and the social expectation of what is necessary, judged against the ethical standards of society in communication with shareholders and other relevant groups.

## 5 *The Auditors' Report*

The emphasis of the approach to the interpretation of “a true and fair view” in company accounts has been that it represents the opinion of the directors. However, although the accounts are prepared on the basis of the judgments and opinions of directors and management, there are established parameters of law and of accounting theory and practice within which these must be contained; and the overview which is taken by the directors of the accounts which are so prepared must adopt the established criteria of what constitutes a true and fair view. The directors are required to prepare accounts which give a true and fair view; the auditors' responsibility, in this connection, is to be satisfied on the basis of their audit (which includes examination of the accounting records, assessment of the evidence which is produced to them, evaluation of the internal control, and consideration of such other explanations and information as they may require) that the view which is given by these accounts can be considered to be a true and fair one.\*

The auditors' responsibility is to ensure that the criteria have been met and to reassure the users of the accounts that this is so, or to say in what respects it is not. It is essential to remember that, because of the basis on which the accounts are prepared, the auditors lend authority to the fact that they give “*a* true and fair view” and not “*the* true and fair view”. As Shaw states, “the audit opinion does not say that the accounts are ‘correct’; it does not imply absolute accuracy; it does not imply that the financial policies and techniques are, in the opinion of the auditors, the only ones, or the ‘best’ ones”.\*\*

This worries some commentators who seek a degree of precision which it is impossible to achieve. What the system does require is the rigorous

\* See Appendix V.

\*\* For further discussion of the auditors' report see J.C. Shaw, “The Audit Report: What it says and what it means”. A monograph of The Institute of Chartered Accountants of Scotland, Gee & Co (Publishers) Ltd, 1980.

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application of the criteria by auditors as the guardians of the interests of all users.

The social utility of the concept of "a true and fair view" is dependent on the capacity of the auditors to monitor it. This requires that auditors have not only a high level of skill and competence in the technical issues of accounting and auditing; it requires that they have also a capacity to inform themselves about, and to exercise judgment on the meaning and significance of those factors which affect the relevance of information and the expectations of users. It is only on this basis that they can arrive at an opinion on the disclosure and presentation of information which satisfies both the legal interpretation and the social perception of what is true and fair in the particular circumstances of each situation.

## 6 *A True and Fair View in Europe*

It is laid down in the Fourth Directive on Company Law, adopted by the Council of the European Communities in 1978, that in respect of the companies to which the Directive applies the annual accounts shall give a true and fair view of the company's assets, liabilities, financial position and profit or loss; and it is provided that, where it is necessary in order to achieve this, additional information must be given and, in exceptional cases, departures from specific provisions of the Directive must be made.

The objective is, of course, to achieve harmonisation in the form and content and in the view given by company annual accounts. The items to be shown in a company's balance sheet and profit and loss account and the principles and rules to be used to determine the amounts to be included in respect of these items will, in accordance with the Directive, be incorporated into the national legislation of the countries concerned as matters of legal prescription. Subject to any changes in the items, the principles or the rules, this should not raise any special problems of implementation for companies in the member states. For at least some of the member states, however, it is a new situation for those who are responsible for the preparation of company accounts to have the independent responsibility, as a matter of legal obligation, to consider whether the accounts which have been prepared strictly in accordance with the principles and the rules *do* give a true and fair view, and whether additional information or some departure is required to enable this to be done.

The concept of an overriding reporting standard of "a true and fair view" is a new one for some member states. To the extent that the concept is an evolution of British cultural and jurisprudential tradition there may be difficulties of assimilation in states where the tradition is different; and, to the extent that the interpretation of "true and fair" in relation to company accountability has some cultural dependence, some variations in practice beyond the prescriptive minimum are likely to result, because of the difference in the institutional, legal and social context.

## A TRUE AND FAIR VIEW IN EUROPE

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The importance of the acceptance in the member states of the European Community of the philosophy of “a true and fair view” in company reporting is in the recognition that this is a standard of a higher order than any prescriptive requirement; and that it thus provides a legal sanction against those responsible for the preparation of company accounts who fail to remedy the effect of inadequacy, deficiency or bias in the rules or of other shortcomings of detailed prescription, or otherwise to respond positively on their own initiative for the protection of shareholders and third parties.

# *Appendix I*

COMPANIES ACT 1948, SCHEDULE 8, PART II, PARAGRAPHS 10-14

## ACCOUNTING PRINCIPLES

10. The company shall be presumed to be carrying on business as a going concern.
11. Accounting policies shall be applied consistently from one financial year to the next.
12. The amount of any item shall be determined on a prudent basis, and in particular –
  - (a) only profits realised at the balance sheet date shall be included in the profit and loss account; and
  - (b) all liabilities and losses which have arisen or are likely to arise in respect of the financial year to which the accounts relate or a previous financial year shall be taken into account, including those which only become apparent between the balance sheet date and the date on which it is signed on behalf of the board of directors in pursuance of section 155 of this Act.
13. All income and charges relating to the financial year to which the accounts relate shall be taken into account, without regard to the date of receipt or payment.
14. In determining the aggregate amount of any item the amount of each individual asset or liability that falls to be taken into account shall be determined separately.

## *Appendix II*

### STATEMENTS OF STANDARD ACCOUNTING PRACTICE ISSUED TO 31 DECEMBER 1981

1. Accounting for the results of associated companies
2. Disclosure of accounting policies
3. Earnings per share
4. The accounting treatment of government grants
5. Accounting for value added tax
6. Extraordinary items and prior year adjustments
7. [Withdrawn]
8. The treatment of taxation under the imputation system in the accounts of companies
9. Stocks and work in progress
10. Statements of Source and Application of Funds
11. [Replaced by No 15]
12. Accounting for depreciation
13. Accounting for research and development
14. Group accounts
15. Accounting for deferred taxation
16. Current cost accounting
17. Accounting for post balance sheet events
18. Accounting for contingencies
19. Accounting for investment properties.

## *Appendix III*

### STATEMENT OF STANDARD ACCOUNTING PRACTICE NO. 16, SECTION III, STANDARD ACCOUNTING PRACTICE, PARAGRAPHS 46-62

#### *Scope*

46. This Standard applies to all annual financial statements intended to give a true and fair view of the financial position and profit or loss other than those of entities falling within the categories listed below:

- (a) entities which do not have any class of share or loan capital listed on The Stock Exchange and satisfy at least two of the following three criteria:
  - (i) they have a turnover of less than £5,000,000 per annum;
  - (ii) their balance sheet total\* at the commencement of the relevant accounting period is less than £2,500,000 as shown in the historical cost accounts;  
and
  - (iii) the average number of their employees in the United Kingdom (UK entities) or in the Republic of Ireland (Republic of Ireland entities) is less than 250;
- (b) wholly owned subsidiaries of companies or other entities where the parent is registered in the UK or the Republic of Ireland. This exemption does not apply where the parent is exempted under (c) or (d) below;
- (c)
  - (i) authorised insurers;
  - (ii) property investment and dealing entities, with the exception of such entities as hold the properties of another entity within the group to which this Standard does apply; and

\* For the purposes of this paragraph, the balance sheet total is defined as the total of the following assets:

Fixed assets (net book value) other than investments

Investments

Current assets including prepayments and accrued income (before deduction of current liabilities).

## APPENDIX III

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- (iii) investment trust companies, unit trusts and other similar long-term investment entities; and
- (d) entities whose long-term primary financial objective is other than to achieve an operating profit (before interest on borrowing); such entities may include charities, building societies, friendly societies, trade unions and pension funds.

Where an entity exempted under (c) or (d) above has subsidiaries which are not themselves exempted under these sections and which collectively exceed the limit in (a) above, the group accounts should include consolidated current cost information in respect of such subsidiaries.

47. Annual financial statements of entities coming within the scope of the Standard should include, in addition to historical cost accounts or historical cost information, current cost accounts prepared in accordance with this Standard. The current cost accounts should contain a profit and loss account and balance sheet, together with explanatory notes, disclosing the information set out in paragraphs 55-59.

48. This requirement to include current cost accounts in addition to historical cost accounts or historical cost information can be complied with by:

- (a) presenting historical cost accounts as the main accounts with supplementary current cost accounts which are prominently displayed; or
- (b) presenting current cost accounts as the main accounts with supplementary historical cost accounts; or
- (c) presenting current cost accounts as the only accounts accompanied by adequate historical cost information. The historical cost disclosure requirements will be clarified when the EEC Fourth Directive is enacted in UK/Irish law. Meanwhile, an entity preparing current cost accounts as its only accounts should provide at least sufficient information to enable the user to ascertain the historical cost profit of the period under existing conventions.

### *The Current Cost Profit and Loss Account*

49. The current cost operating profit\* is derived by making the following main adjustments to the historical cost trading profit (before interest on net borrowing\*) to allow for the impact of price changes on the funds needed to maintain the net operating assets\*:

- (a) in relation to fixed assets, a depreciation adjustment being the differ-

\* As defined in the definitions section of the Standard.

## APPENDIX III

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- ence between the proportion of their value to the business\* consumed in the period and the depreciation calculated on the historical cost basis;
- (b) in relation to working capital:
    - (i) a cost of sales adjustment being the difference between the value to the business and the historical cost of stock consumed in the period; and
    - (ii) an adjustment based on monetary working capital\*.

50. Where a proportion of the net operating assets is financed by net borrowing, a gearing adjustment is required in arriving at the current cost profit attributable to the shareholders\*. This should be calculated by:

- (a) expressing net borrowing as a proportion of the net operating assets using average figures for the year from the current cost balance sheets; and
- (b) multiplying the total of the charges or credits made to allow for the impact of the price changes on the net operating assets of the business by the proportion determined at (a).

This adjustment, normally a credit, could be a debit if prices fall.

51. No gearing adjustment should be made in the profit and loss accounts of Nationalised Industries in view of the special nature of their capital structure. Accordingly, in such cases interest on their net borrowing should be shown after taxation and extraordinary items.

52. The treatment within the current cost profit and loss account of gains and losses on asset disposals, extraordinary and exceptional items, prior year items, income from associates, group consolidation adjustments, minority interests and the translation of foreign currencies should, where practicable, be consistent with the definitions of profit set out in this Standard. Where this is impracticable the treatment adopted should be disclosed in a note to the current cost accounts.

### *The Current Cost Balance Sheet*

53. Assets and liabilities should be included in the balance sheet, as far as practicable, on the following bases:

- (a) Land and buildings, plant and machinery and stocks subject to a cost of sales adjustment – at their value to the business.
- (b) Investments in associated companies – either at the applicable propor-

\* As defined in the definitions section of the Standard

## APPENDIX III

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tion of the associated companies' net assets stated under this Standard or, where such information is not readily available, at directors' best estimate thereof. Allowance for premium or discount on acquisition should be made as stated under (e) below.

- (c) Other investments (excluding those treated as current assets) – at directors' valuation. Where the investment is listed and the directors' valuation is materially different from mid-market value, the basis of valuation and the reasons for the difference should be stated.
- (d) Intangible assets (excluding goodwill) – at the best estimate of their value to the business.
- (e) Goodwill (premium or discount) arising on consolidation – on the basis set out in SSAP 14. Where goodwill is carried at an amount established before the introduction of SSAP 14 it should be reduced to the extent that it represents revaluation surpluses relating to assets held at the date of the acquisition.
- (f) Current assets, other than those subject to a cost of sales adjustment – on the historical cost basis.
- (g) All liabilities – on the historical cost basis.

54. Reserves in the current cost balance sheet should include revaluation surpluses or deficits and adjustments made to allow for the impact of price changes in arriving at current cost profit attributable to shareholders. Amounts to reduce assets from net current replacement cost to recoverable amount\* should be charged to the profit and loss account.

### *Contents of Accounts*

#### Profit and Loss Account

55. The current cost profit and loss account should show (not necessarily in this order):

- (a) the current cost operating profit or loss;
- (b) interest/income relating to the net borrowing on which the gearing adjustment has been based;
- (c) the gearing adjustment;
- (d) taxation;
- (e) extraordinary items; and
- (f) current cost profit or loss (after tax) attributable to shareholders.

56. A reconciliation should be provided between the current cost operating profit and the profit or loss before charging interest and taxation calculated on the historical cost basis giving the respective amounts of the following:

\* As defined in the definitions section of the Standard.

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- (a) depreciation adjustment;
- (b) cost of sales adjustment;
- (c) monetary working capital adjustment and, where appropriate, interest relating to monetary working capital; and
- (d) other material adjustments made to profits calculated on the historical cost basis when determining current cost operating profit.

The adjustments for cost of sales and monetary working capital may be combined.

### Balance Sheet

57. The current cost balance sheet (which may be in summarised form when a full historical cost balance sheet is disclosed) should show the assets and liabilities of the entity on the bases required by this Standard. Notes to the balance sheet should disclose the totals of net operating assets and net borrowing and their main elements. The balance sheet should be supported by summaries of the fixed asset accounts and the movements on reserves.

### Notes to the Accounts

58. The notes attached to the current cost accounts should describe the bases and methods adopted in preparing the accounts particularly in relation to:

- (a) the value to the business of fixed assets and the depreciation thereon;
- (b) the value to the business of stock and work in progress and the cost of sales adjustment;
- (c) the monetary working capital adjustment;
- (d) the gearing adjustment;
- (e) the basis of translating foreign currencies and dealing with translation differences arising;
- (f) other material adjustments to the historical cost information; and
- (g) the corresponding amounts.

### Earnings per Share

59. Listed companies should show the current cost earnings per share based on the current cost profit attributable to equity shareholders before extraordinary items.

### Group Accounts

60. A company which is the parent company of a group and which is required to produce current cost group accounts should produce such group accounts in accordance with the principles set out in this Standard. It need not, however, produce current cost accounts for itself as a single company where historical cost accounts are the main accounts.

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### Corresponding Amounts

61. In all accounts prepared in accordance with this Standard, corresponding amounts for the preceding period should be stated. However, unless current cost accounts are the main accounts, corresponding amounts need only be included for the first period for which current cost accounts are prepared if they are readily available.

### *Relationship with Other Standards*

62. Existing Standards issued for use with historical cost accounts apply to current cost accounts except where a conflict exists caused by the conceptual difference between the systems. The four fundamental accounting concepts in SSAP 2 should be observed and information on accounting policies should be given. The source and application of funds statement required by SSAP 10 should be compatible with the main accounts.

## *Appendix IV*

### STATEMENT OF STANDARD ACCOUNTING PRACTICE NO. 10

#### STATEMENTS OF SOURCE AND APPLICATION OF FUNDS, SECTION III, STANDARD ACCOUNTING PRACTICE, PARAGRAPHS 9-12

9. This accounting standard shall apply to all financial accounts intended to give a true and fair view of financial position and profit or loss other than those of enterprises with turnover or gross income of less than £25,000 per annum.
10. Audited financial accounts should, subject to paragraph 9 above, include a statement of source and application of funds both for the period under review and for the corresponding previous period.
11. The statement should show the profit or loss for the period together with the adjustments required for items which did not use (or provide) funds in the period. The following other sources and applications of funds should, where material, also be shown:
- (a) dividends paid;
  - (b) acquisitions and disposals of fixed and other non-current assets;
  - (c) funds raised by increasing, or expended in repaying or redeeming, medium or long-term loans or the issued capital of the company;  
and
  - (d) increase or decrease in working capital sub-divided into its components, and movements in net liquid funds.
12. Where the accounts are those of a group, the statement of source and application of funds should be so framed as to reflect the operations of the group.

## *Appendix V*

### COMPANIES ACT 1967, SECTION 14 – AUDITORS' REPORT

14. (1) The auditors of a company shall make a report to the members on the accounts examined by them, and on every balance sheet, every profit and loss account and all group accounts prepared under section 1 of the Companies Act 1976 (or under that section taken with section 150 of the principal Act), of which, in accordance with section 1(6) of the said Act of 1976, a copy is laid before the company in general meeting during their tenure of office.

(2) The auditors' report shall be read before the company in general meeting and shall be open to inspection by any member.

(3) The report shall –

(a) except in the case of a company that is entitled to avail itself, and has availed itself, of the benefit of any of the provisions of Part III of Schedule 8A to the principal Act, state whether in the auditors' opinion the company's balance sheet and profit and loss account and (if it is a holding company submitting group accounts) the group accounts have been properly prepared in accordance with the provisions of the Companies Acts 1948 to 1981 and, without prejudice to the foregoing, whether in their opinion a true and fair view is given –

(i) in the case of the balance sheet, of the state of the company's affairs as at the end of its financial year;

(ii) in the case of the profit and loss account (if it be not framed as a consolidated profit and loss account), of the company's profit or loss for its financial year;

(iii) in the case of group accounts submitted by a holding company, of the state of affairs and profit or loss of the company and its subsidiaries dealt with thereby, so far as concerns members of the company;

(b) in the said excepted case, state whether in the auditors' opinion the

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company's balance sheet and profit and loss account and (if it is a holding company submitting group accounts) the group accounts have been properly prepared in accordance with the provisions of the Companies Acts 1948 to 1981.

(4) It shall be the duty of the auditors of a company, in preparing their report under this section, to carry out such investigations as will enable them to form an opinion as to the following matters, that is to say, —

(a) whether proper accounting records have been kept by the company and proper returns adequate for their audit have been received from branches not visited by them; and

(b) whether the company's balance sheet and (unless it is framed as a consolidated profit and loss account) profit and loss account are in agreement with the accounting records and returns;

and if the auditors are of opinion that proper accounting records have not been kept by the company or that proper returns adequate for their audit have not been received from branches not visited by them, or if the balance sheet and (unless it is framed as a consolidated profit and loss account) profit and loss account are not in agreement with the accounting records and returns, the auditors shall state that fact in their report.

(5) Every auditor of a company shall have a right of access at all times to the books and accounts and vouchers of the company, and shall be entitled to require from the officers of the company such information and explanation as he thinks necessary for the performance of the duties of the auditors.

(6) If the auditors fail to obtain all the information and explanations which, to the best of their knowledge and belief, are necessary for the purposes of their audit, they shall state that fact in their report.

(7) The auditors of a company shall be entitled to attend any general meeting of the company and to receive all notices of, and other communications relating to, any general meeting which any member of the company is entitled to receive, and to be heard at any general meeting which they attend on any part of the business of the meeting which concerns them as auditors.

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A TRUE AND FAIR VIEW  
IN COMPANY ACCOUNTS

*Distributed by:*  
**VAN NOSTRAND  
REINHOLD (U.K.)  
MOLLY MILLARS LANE  
WOKINGHAM, BERKS.  
RG11 2PY, ENGLAND**

