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A TRUE AND FAIR VIEW: A REVISED "ACCOUNTING INTERPRETATION"

by John B. Ryan

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OCCASIONAL PAPER NO. 1
I. Introduction and summary

The purpose of this article is to provide an interpretation of the "true and fair view" statutory standard that is consistent with recent developments in accounting theory emphasising the central role of relevance and reliability, both accepted today as key concepts in explaining accounting measurements in external financial reporting.

The interpretation advocated equates fairness with relevance together with appropriate disclosure, and true with correspondence of two kinds, both of which are necessary for accounting information to be reliable. Empirical correspondence refers to a one-to-one relationship, or correspondence, between the measurements of assets and liabilities reported in financial statements and the actual quantity they purport to measure. Secondly, these measurements should be consistent with or correspond to the specific concepts of capital and profit being measured in a particular set of accounts; i.e., the measurements should be internally consistent and deductively valid in relation to the interpretation of the accounting system being applied. The application of this interpretation requires the identification of users and their financial information needs, and the selection of an appropriate reporting model or models.

This interpretation could not be described as "simple" or "obvious".

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This is a revision of my paper which first appeared in Emanuel D.M. and I.C. Stewart (Eds.) Essays in Honour of Trevor R. Johnston. 1980

I wish to acknowledge the helpful comments of Allan Coote, Errol Moore and Garry Tibbits. The usual disclaimer applies.
However, no generally accepted interpretation has emerged from the many articles on the subject. There is little disagreement with the notion that a "true and fair view" is a legal concept, and that its interpretation in relation to a particular company's accounts could, in the final analysis, only be determined authoritatively by a court. I believe that it is not sufficiently appreciated that, as stated in the 1983 legal opinion obtained by the United Kingdom Accounting Standards Committee, it is "an abstraction or philosophical concept expressed in simple English" (p.155). Moreover, the same opinion stressed that "the meaning of true and fair remains what it was in 1947. It is the content given to the concept which has changed" (p.156). Before accepting these propositions, it is relevant to ask what is the general abstract meaning which is unchanging, and how does its content change over time. The article addresses these issues.

While it is no doubt relevant for writers to ponder the general or philosophical meaning of "true and fair", and how it may be applied, company directors and auditors have statutory responsibilities to be met, and it is not surprising, therefore, that their approach has been to follow the accounting standards recommended by the professional bodies. Notwithstanding the obligation imposed on directors under s.269(8A) of the Companies Code to comply with "applicable approved accounting standards" issued by the Accounting Standards Review Board (ASRB), the obligation for accounts to give a true and fair view remains overriding s.269(8B). It is rather ironic that these 1983 amendments, in effect conferring statutory backing on the profession's standards through the ASRB, at the same time reserve the position whether financial statements so prepared do thereby give a true and fair view. The uncertainty attaching to this approach is worrying to both directors and auditors.

However, it seems reasonable to assert that the weight of argument is
in favour of an overriding general standard with specific disclosure mandated, as appropriate, in Schedule 7 or accounting standards. But having complied with specific disclosure requirements, on what grounds are the directors and auditors expected finally to form an opinion that the accounts do give a true and fair view? The paper addresses this and related questions.

While a general, philosophical, standard expressed in simple English has the obvious advantage of simplicity—and clarity, at that level—that does not mean that its application to complex financial statements is simple. Far from it. Although the standard’s application proceeds through several steps to technical rules of accounting, the explanation itself accords words their ordinary or popular meaning. For example, working from the notion of “compliance with the facts”, “truth” is equated with empirical correspondence. As this is not a sufficient condition for truth, it is expanded to include deductive validity. The interpretation of “fair” as relevant provides the key to the interpretation of the general accounting model for measurement of periodic profit and capital. It is at this point that detailed technical rules are necessary for the application of the particular model. Thus there need be no opposition between giving true and fair their ordinary meaning, and the use of technical rules (accounting standards) in financial statements.

The article is organised as follows. The evolutionary development of true and fair is sketched in Part II. Because of the importance of accounting measurement to my explanation, Part III outlines the essence of accounting measurement, including the double entry calculus for periodic profit and capital measurement. The formal calculus is shown in Appendix A. The nature of truth as applied to external financial
reporting is examined in Part IV. Part V represents a substantial revision of my 1980 interpretation of fair. Part VI draws on American practice in assessing "present fairly" as an alternative general standard. The interpretations of true and fair are brought together and summarised in Part VII. Part VIII considers the application of the general standard to four information needs of shareholders. Significant developments in professional opinion are outlined in Part IX.

Finally, the implications for accounting, were my explanation adopted are considered in Part X. The "general purpose" view of financial statements would be replaced by "specific purpose" in relation to the recognised information needs of users. Accounting standards would be reviewed in light of this new approach. Directors and accountants would need to identify the model being used in their statement of accounting policies, and auditors similarly in their audit report. And, as a consequence of this user driven approach, there could well be more than one true and fair view of profit and of the state of affairs of the one company at the same time.

Two matters not considered in this paper should be mentioned. The first is an analysis of legal decisions bearing on the function of accounts, including the meaning of capital and profits, especially profits available for dividend. This topic warrants a separate paper. Because there are no legal decisions specifically on the interpretation of a true and fair view, such an analysis would be unlikely to affect my conclusions, particularly as my interpretation does not depend on a particular concept of capital and profit. Readers who believe that there is one absolute, immutable, concept of profit applicable in all circumstances are unlikely to accept this approach.
The second matter relates to the liability of auditors in respect of the duty of care owed to persons who, relying on their expression of opinion on the financial statements, suffer loss. The courts have interpreted this liability very widely. But does it follow that the responsibility to report is equally extensive? It appears to the writer that, before a duty to take care can be exercised, there must first be an obligation to report, or acceptance of the need to report. Without in any way affecting the extensiveness and generality of the duty to take care a means of deciding on the measurement base to be used in discharging the responsibility to report must be found. These are two independent issues, the first of which is not dealt with in this paper.

II. Evolutionary development

The UK Joint Stock Companies Act of 1844, which introduced incorporation by registration, required books of account to be kept, a "full and fair" balance sheet to be presented to each ordinary meeting of shareholders, auditors to be appointed and given access to the books and officers of the company, and the audited balance sheet to be filed with the Registrar of Joint Stock Companies. Similar provisions were extended to parliamentary companies by the Companies Clauses Consolidation Act of 1845. As noted by Professor Baxt,1 s.110 of this Act required officers to make out a "true and perfect" account of moneys received and s.111 required directors to keep "true and full" accounts of moneys received and expended.

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1 1968, p.301. Baxt described this as an "early enlightened approach". Because of the explicit emphasis given to money I would agree. However, Baxt believed the use of these terms offered support for the Chambers' model whereas I believe they offer support for the monetary capital and profit measurement model.
The full disclosure provided for in these early statutes suffered a set back not to be recovered from for 70 years when the compulsory requirements, in accordance with the prevailing doctrine of laissez-faire, were abandoned. The provisions relating to accounts and audit were relegated to an optional set of articles. Table B of the 1856 UK Joint Stock Companies Act. The following provisions of those articles are worth noting. The number of the relevant article is shown in brackets.

Dividends were restricted to "profits arising from the business of the company" (64). Before recommending a dividend directors were authorised to set aside funds for contingencies or for equalising dividends (65). "... true accounts were to be kept of the stock ... of the sums of money received and expended ... of the credits and liabilities of the company ... upon the principles of double entry" (69). A printed copy of the balance sheet was to be sent to shareholders seven days prior to the general meeting (73). Auditors were required to report to the shareholders on the "balance sheet and accounts", stating whether "in their opinion. the balance sheet is 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" (84) (my emphasis). The auditor was empowered to employ an accountant to assist him (83). The reference to the principles of double entry was dropped from Table A of the 1862 Consolidating Act.

Article 71 of the 1856 optional set of articles also required a Statement of the Income and Expenditure to be presented by the directors before the company in general meeting. In view of the persistent misunderstanding of the relationship between profit measurement and measurement of assets in the balance sheet this article is worth quoting in full hereunder. Apparently at least the draftsman understood the relationship.
The Statement so made shall show, arranged under the most convenient Heads, the Amount of gross Income, distinguishing the Several Sources from which it has been derived, and the Amount of gross Expenditure, distinguishing the Expense of the Establishment, Salaries, and other like Matters: Every Item of Expenditure fairly chargeable against the Year's Income shall be brought into Account, so that a just Balance of Profit and Loss may be laid before the Meeting; and in Cases where any Item of Expenditure which may in Fairness be distributed over several Years has been incurred in any One Year the whole Amount of such Item shall be stated, with the addition of the Reasons why only a Portion of such Expenditure is charged against the Income of the Year.

The Companies Act of 1900 required every company registered under the Companies Acts to appoint an auditor, and in 1907 all registered companies were required to file an audited balance sheet with their annual return. But it was not until 1928 that legislation was enacted requiring the balance sheet and profit statement to be forwarded to shareholders. With the notable exception of the Victorian Companies Act of 1896 this pattern of legislation was largely followed in the Australian Commonwealth and New Zealand.

The requirement for the balance sheet of companies adopting Table B of the 1856 UK Act to show "a true and correct view" was continued until 1947, when the Cohen Committee's recommendation of "a true and fair view" was adopted and, by inclusion in the Fourth Directive in 1978, is now applicable in the European Community.

The Victorian Companies Act of 1955 was the first Australian Act to follow the 1947 UK amendment, which was generally adopted through incorporation in the 1961 Uniform Companies Acts.

Following adoption of the co-operative scheme, the present statutory requirements are set out in the 1981 NSW Companies Code. References throughout this article are to that Code. I have assumed that readers are familiar with the main provisions relating to accounts. A far reaching amendment enacted in 1983 requires directors to ensure that the financial
statements are made out in accordance with "applicable approved accounting standards". As previously mentioned, this requirement is subject to the overriding obligation of directors to ensure that the accounts give a true and fair view.

III. The essence of accounting measurement

Consideration of a true and fair view raises questions regarding what is, or ought to be, measured in company financial statements. For a full assessment of the interpretation advocated it is necessary to understand my position on accounting measurement, and how it can be applied. The propositions put forward form an integral part of my overall theory of financial accounting.

All measurement is governed by the purpose of the measurement. The essence of accounting measurement is the bringing together, in a common relationship, of the financial transactions or events of a particular entity for the purpose of measuring their net effect. The main elements comprise the purpose, the common relationship, financial transactions or events and the unit of measure. The purpose determines the nature of the common relationship and the unit of measure. Rules derived from the purpose are required to bring the financial transactions or events into a common relationship, thereby enabling their net effect to be measured.

Applying this approach to the annual financial statements of companies, shareholders have an obvious and direct interest in the amount of profit, particularly in relation to dividends and capital maintenance. Profit is the "net effect" or change resulting from transactions or events (excluding those with the owners themselves). Profit measurement calls for a consistent set of rules relating the amount of profit both to changes in
assets and liabilities, and to the change in capital. In the absence of transactions with the owners, the basic measurement problem can be expressed simply as:

\[ \text{Profit} = \text{change in net assets} = \text{ending capital} - \text{beginning capital}. \]

This then is the common relationship. The formal structure specifying these relationships is referred to as the double entry calculus, and is shown in Appendix A.

The double entry calculus\(^2\) is the uninterpreted axiomatic system stating the relationships between the elements of the system for the measurement of periodic profit. It is described as axiomatic because the theorems (conclusions) follow logically from the axioms (premisses).

It is described as uninterpreted because, as a general abstract system, it does not convey specific meaning, and rules of application (or, in the jargon of the philosophy of science, semantical rules of interpretation) must be applied in order to confer meaning on its primitive terms.

"Capital" and "the unit of measure" are the primitive terms. Specific meaning is conferred on them using the rules of application, which call for identification of users and their information needs. Once specific meaning is conferred on capital and the unit of measure, then that meaning flows to the remaining elements, including profit, through the axioms and definitions. It is possible, of course, depending on the information needs which are recognised, that more than one interpretation of the double entry calculus may be required. The application of each interpretation will result in a separate set of financial statements: i.e. a different measurement of capital and profit.

\(^2\) I have followed the meaning given calculus and related terms by Rudner (1966).
The term model is used to refer to a particular interpretation of the double entry calculus, the monetary model being the model for the measurement of monetary capital and profit. Other models are the current purchasing power (CPP), current cost accounting (CCA) and continuously contemporary accounting (CoCoA). Although there are many similarities, each model has its own set of measurement rules, derived from their respective interpretations of the double entry calculus. It should be mentioned that historical cost accounting and the monetary model would coincide and give the same results were it not for departures in practice from historical cost through revaluations or quasi valuations of assets.

This concludes the outline of my position on accounting measurement as it applies to periodic profit measurement. It will be drawn on and elaborated as necessary throughout the article. The consequences of accepting the approach that "different capital and profit measurement models are required for different purposes" should be noted.

First, a model should not be criticised for not measuring something it was never intended to measure. For example, it would be inappropriate to criticise the CPP model for not measuring non-monetary assets in the balance sheet at their current cost: that is a function of the CCA model.

Secondly, accounting information extracted from a particular set of financial statements should be interpreted with care. Many of the measurements will only make sense in relation to the information need they were designed to satisfy. Assuming that information needs or intended purposes of the accounts are prominently displayed, then anyone using them for other purposes would do so at their own risk.

Thirdly, much of the criticism of the traditional balance sheet is based on a lack of appreciation of the relationship between the profit statement and the balance sheet. There is a general failure to understand that the amounts at which assets are stated in the balance sheet reflect
their significance in the measurement of profit. If the objective is to measure profits after maintaining capital, then related and consistent concepts of capital and profit must be applied. The strength of the double entry calculus is that it spells out these relationships simply and clearly (See, for example, Equation (3) of Appendix A, stipulating the content of profit). Most of the debate on the meaning of true and fair has concentrated on the measurement basis used for assets in the balance sheet.

Professor Johnston (1978, pp.9-10) drew attention to the virtual omission of the profit and loss account from discussions of the meaning of true and fair. Moreover, he submitted that the popular meaning of profit as a monetary gain coincided with the historical cost concept applied in "accepted accounting principles". Were monetary profit being properly measured in the profit statement, then, as a consequence, fixed assets should be measured in the balance sheet at the lower of written down cost or recoverable amount. Anyone who accepted the former could not deny the latter, and claim to be consistent regarding measurement of capital and profit. There would, of course, be some who reject the monetary model, but that is another issue, and there may be some who, rejecting "articulation", claim consistency on other grounds.

IV. WHAT IS TRUTH?

Writing in 1938, Kenneth MacNeal was forthright in expressing the following opinion:

The facts disclosed herein lead unavoidably to a conclusion that the great majority of financial statements must necessarily be untrue and misleading due to the unsound principles upon which modern accounting methods are based... For more than four hundred years, since the publication of Pacioli's book on double entry bookkeeping in 1494, accounting methods, and hence accounting reports, have been based on expediency rather than on truth (p.vii).
... if accounting principles are revised so that the public may be supplied with that thing which is of greatest value to it, namely, the truth, then I do not think it unreasonable to look forward to a time when the profession will occupy a position of public respect and esteem of which it does not dream today (pp.x and xi) (my emphasis).

In selecting his work thirty-two years later as the first in the Scholars reprint series "Classics in Accounting" Professor Sterling wrote that it "reaches conclusions similar to those reached by contemporary researchers ..." (p.vi). Unresolved, the issue of what is truth in accounting remains a burning one today.

My purpose in this part is to examine the applicability to accounting of the four concepts of truth reviewed by J.C. Dyer II in a thoughtful analysis. These were: true by definition, truth as correspondence, truth as coherence and pragmatic truth. Each will be considered in turn.

True by definition can be is dismissed fairly quickly. Using this approach we might be tempted to define "true" in financial statements to mean that the measurements reported therein had been prepared in accordance with approved accounting standards. However, as the true and fair view statutory standard is overriding, and directors will not be relieved of this responsibility simply by relying on accounting standards, this approach is of little help in resolving the fundamental question.

The philosophical notion of "correspondence", according to Dyer, defines truth "as an equation of thought to object (or object to thought)" (p.194). He writes that

the proposition 'cash was $10,000' is true because it corresponds with, is related to, conforms to something extraneous to itself. This extraneous body is generally referred to as a fact, state of affairs, or even reality (pp.194-5; see also p.190).

The Financial Accounting Standards Board (FASB) has referred to this property as "representational faithfulness", defining it in SFAC No.2 as:

Representational faithfulness is correspondence or agreement between a measure or description and the phenomenon it purports to represent. In accounting, the phenomena to be represented are economic resources and obligations and the transactions and events that change those resources and obligations (paragraph 63).
Professor Chambers used "isomorphic" (1966, p.126) to describe a similar property.

Truth as correspondence is based on the equality between a statement and what it purports to measure. Dyer refers to the latter as a fact, state of affairs or even reality. Because of its relationship to facts, this concept of truth as correspondence will be referred to as empirical correspondence. (This will serve to distinguish it from analytical correspondence discussed later.) Thus, the first conclusion is that this concept of truth as empirical correspondence, or representational faithfulness, is obviously applicable to measurements disclosed in financial statements: that is, they should measure the property they purport to measure. This correspondence will enhance the reliability of financial statements.

The way forward from here is not so clear. Dyer appears to treat "state of affairs" as synonymous with "facts" and, as is well known, the balance sheet is required to give "a true and fair view of the state of affairs of the company ..." (s.269(2)). It might therefore be concluded that he would regard a balance sheet as true if its measurements corresponded with the facts. However, he later adopts a narrower definition of facts as something "brute, inescapable" and proceeds to argue on that basis that measurements like "fixed assets at cost less accumulated depreciation" do not have meaning because the net amount does not correspond to such a fact.

Two issues now need to be clarified. The first is to demonstrate that correspondence with the facts alone is not a sufficient condition for profit measurement, even where the facts are clear and complete as, for
example, in the case of a terminated enterprise. Correspondence with a set of related ideas, or analytical structure for processing the facts is also required. Furthermore, an analytical framework is needed for distinguishing the relevant facts.

Secondly, the economic consequences of many transactions are incomplete at balance date and Dyer's notion of "correspondence" needs extension to accommodate them because it would not be possible to measure periodic profit were they ignored.

Returning to the first issue, consider the case of a sole trader who commenced business with a cash contribution of $20,000 and on termination of the business a year later had $50,000 cash after satisfaction of the claims of creditors. There being no further contributions of capital or withdrawals by the owner, profit for the year may be measured at $30,000.

The first point to note is that even in this simple case it was not possible to measure profit by reference only to the two facts given of the opening cash and the closing cash. It was necessary to use the relationship that, assuming there were no further contributions of capital or withdrawals by the owner, profit equals ending capital less beginning capital. The amount of capital was established in each case by reference to the amount of cash, obviously "empirical correspondence".

However, this empirical step was taken within the framework of a particular set of ideas about the concepts of capital and profit, assets and liabilities and their relationship. These relationships were explained briefly on pages 8 to 11, with the formal statement of the double entry calculus being set out in Appendix A. The calculus provides the analytical framework for processing the facts for the purpose of measuring profit. Our interpretation of the facts (the beginning and ending cash) would differ, for example, were an outstanding creditor's account of $5,000 discovered; ending capital and thus profit should be reduced by that amount. Thus the second conclusion to be drawn is that the facts should be processed in
accordance with the rules of the relevant analytical framework. If they are so processed, then the measurements disclosed in the financial statements will correspond to the relationships of the double entry calculus. This property is referred to as analytical correspondence.

It should also be noted that my earlier conclusion from this example that "profit for the year may be measured at $30,000", assumed that the concept of profit being measured was money profit. Were another concept of profit relevant, purchasing power profit for instance, then either the opening or closing capital would require restatement to convert the money sums to comparable measures of purchasing power, resulting in a different profit figure. Suppose, for example, that the general price level had risen by 10% over the year. To measure profit, in terms of purchasing power at the end of the year, the opening capital should be restated as $22,000, giving a purchasing power profit of $28,000.

In each of the above cases, a different quantity of the assets (money or purchasing power) was being measured, each being based on a different interpretation of the double entry calculus. Each measurement of profit could be described as "true" in terms of the quantity being measured, leading to the third conclusion that several different interpretations of the double entry calculus could meet the truth conditions established for both empirical and analytical correspondence.

Which interpretation is relevant will depend on the users' information needs. Referring to the above example, if the information need of the owner was to ascertain the amount of profit after maintaining purchasing power capital, then purchasing power is the relevant quantity. How meaning is conferred on capital and the unit of measure from the users' information needs is considered in the next part on "fair".
It is now possible to explain why Dyer, relying on his analysis of truth as correspondence with the facts, is not able to explain the meaning or "truth value" of the statement that "Building (less accumulated depreciation) was $165,000" (p.196), and was led to conclude that it has no truth value.

For the purpose of analysis here the statement is expanded to include a cost figure so that it reads:

<p>| | |</p>
<table>
<thead>
<tr>
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<tbody>
<tr>
<td>Building, at cost</td>
<td>$171,875</td>
</tr>
<tr>
<td>Less accumulated depreciation (1 year @ 4% p.a. on cost)</td>
<td>6,875</td>
</tr>
<tr>
<td></td>
<td>$165,000</td>
</tr>
</tbody>
</table>

It is assumed that the directors have estimated the economically useful life of the building as twenty-five years, and have decided to depreciate it at 4% per annum on cost. In addition, the recoverable amount at balance sheet date has been estimated at $190,000.

Dyer argues that:

The fact that there might be evidence to indicate historical cost (or any other value concept) only suggests that the building has value - not a value which is required to constitute an inescapable and indisputable fact (p.197).

Care is needed here not to be drawn into the trap, unwittingly set by Dyer, of equating "an inescapable and indisputable fact" with "a value". This is seen as too restrictive and limiting for the purpose of periodic profit measurement. The starting point for truth as correspondence was, and remains, correspondence with the facts - not with "a value". There is no problem if value is used in a completely general sense so that it could relate to any amount generated by a measurement system.
Analytical correspondence can be explained in this case by reference to the monetary model. Under this interpretation of the double entry calculus, capital is monetary capital and money is the unit of measure. The derived notion of profit is monetary profit. Two rules derived from the concept of monetary profit for the purpose of measuring periodic profit are the cost allocation rule, and the rule that the written down cost carried forward at balance date should not exceed recoverable amount. The cost allocation rule provides for the money cost (less any estimated scrap value) to be allocated to periods as an expense in the ratio of economic services provided per period to the total services. Given that these rules have been properly applied, then the resultant amount of monetary profit will represent an increase in the monetary capital.

Returning to empirical correspondence, that clearly exists between the statement designated "Building, at cost $171,875". Secondly, the directors estimate of useful life and spread of services should be able to be tested empirically by reference to the life of buildings of similar construction in the area. Because the transaction is incomplete the empirical correspondence of this second test is not as conclusive as the first. Nevertheless, it should be capable of independent verification. Therefore, assuming that both the cost figure and the information underlying calculation of its allocation to periods as depreciation expense satisfy the need for empirical testability, it can be argued that the net amount of $165,000 corresponds with those "facts" which have meaning in the context of periodic monetary profit measurement. This is, of course, not to argue that either the depreciation expense of $6,875 nor the cost carried forward of $165,000 is an independent fact of the same hardness as the initial $171,875 from which they are derived. The $165,000 is carried forward for inclusion at the rate of $6,875 p.a. as an expense in the profit statement for each of the next 24 years.
This example has been used to demonstrate both empirical and analytical correspondence in the measurement of periodic profit of a continuing entity.

The third concept of truth to be examined is truth as coherence and, as explained by Dyer, according to this view "truth is not found in correspondence of propositions with facts, but rather in the relationship of propositions to each other. This relationship, when exposed, must be logical, that is, a composition of consistency and mutual entailment" (p.197).

Internal consistency of propositions is at the heart of this concept. It may also be described as analytical or structural validity. Does this concept have relevance to the propositions contained in a set of financial statements? And, if so, to what specifically does it apply, and how is it to be applied?

It is believed that this concept of coherence applies to the underlying relationship fundamental to a set of financial statements, for example, the relationship between capital and profit, owners' equity and assets less liabilities. These structural relationships are embodied in the double entry calculus, and provided it is coherent, or internally consistent, then the proper application of derived rules for the measurement of profit and the state of affairs should ensure that the actual measurements are likewise consistent. The structural relationship may be likened to the bones of the body, whereas the actual transactions provide the flesh and impart specific meaning to the whole. Thus truth as coherence has its application to financial statements through the proper application of the rules of the relevant interpretation of the double entry calculus. It is complementary to truth as analytical correspondence.
Whereas analytical correspondence was used to describe the relationship between the double entry calculus and measurements employed in financial statements, coherence refers to the internal consistency of the relationships of the double entry calculus itself. If in fact they were not consistent then the structure would be defective.

In discussing coherence Dyer specifically refers to the accounting equation but, having rejected its applicability on the basis of an Alice in Wonderland analogy, endeavours unsuccessfully to apply it to generally accepted accounting principles and finally concludes that truth as coherence is not applicable. In the course of this analysis he asserts that "the most relevant interpretation of the coherence theory view of true in True and Fair is the one which asserts that true has a technical meaning generally accepted by accountants", this notion arising from "the contention that generally accepted accounting principles are in a fashion the axioms of accounting upon which the truth of financial statements rest ..." (p.198). Most theorists would agree with him that accounting principles, or accounting standards, do not have the status of axioms. He does, however, fail to explore other applications of coherence theory which could have led to different conclusions.

Pragmatic truth, the final notion of truth to be considered, may be put crudely as "truth as what works"\(^3\), or that truth lies in "our successful ideas about reality" (Dyer, p.201). To overcome definitional problems and to provide a basis for judging when a belief or idea works, Dyer proposes the rule that a belief works when it is verified. He then endeavours to apply this notion to accounting statements. Whilst

\(^3\) As quoted by Dyer (p.201) from John Hospers An Introduction to Philosophical Analysis, second ed., Routledge and Kegan Paul Ltd., 1967, p.118.
verification defined as "consensus of opinion among qualified observers" has obvious applicability to external financial reporting. It is verification of the transactions, and the application of relevant accounting principles to them, that is being verified which is altogether different from verification of a belief. This notion of pragmatic truth does not, therefore, appear to be relevant.

Three notions of truth have been drawn on to obtain a full understanding of the meaning of true when applied to financial statements. These are empirical correspondence, analytical correspondence and coherence. Because of the complementary relationship between analytical correspondence and coherence, the term analytical validity is used to embrace both concepts.

It is concluded that empirical correspondence and analytical validity are both necessary conditions that financial statements must meet in order for them to be described as "true". Furthermore, this analysis commenced with the ordinary or popular meaning of the words used. Certainly a technical interpretation was not relied upon.

V. What is fair?

What is meant when the opinion is expressed that the financial statements are "fair"? The comparative lack of debate cannot be taken as evidence that fair has a meaning which is generally accepted by professional accountants and auditors. Like true, fair is a term which many lay people would assume to have a clear, generally understood meaning. In addition, fair has a high moral content, going to the integrity of the financial reporting process.

However, choosing words that simultaneously capture the spirit of fair, and explain its application clearly, has proved elusive. The main difficulty is to bridge the gap from the simple expression of the concept
to the technicalities of financial statements. Thus, some writers have advocated a "common law" approach which eschews any attempt to confer precise meaning on "true and fair". Instead an accounting court to resolve financial reporting issues is favoured. Even were such a court appointed, it is believed that the inevitable pressures for a rational explanation of its decisions would lead to their rigorous scrutiny.

In this context I define "fair" to mean that, first and foremost, the accounting information reported is suitable for the information need or purpose of the user; and secondly, that the information has been properly communicated to the user. The first quality is defined as relevance and it is regarded as the primary quality. Secondary qualities stipulate communication criteria for reporting the relevant information. They comprise completeness, materiality, propriety of presentation and timeliness. Because relevance is paramount, no trade-off is permitted with the secondary qualities. My interpretation of relevance is explained first.

The Concise Oxford Dictionary defines relevance as "bearing upon or pertinent to the matter in hand" (1976, p.946). A similar meaning of "bearing upon or connected with the matter in hand; to the purpose; pertinent" is given by The Macquarie Dictionary (1982, p.1459). Applied to financial statements, it would mean that the financial information reported should "bear upon" or be "pertinent to" the information need of the users, that need being the "purpose" or "matter in hand".

The AAA 1966 Committee responsible for ASOBAT (p.7) Barton (1982, pp.27 & 28, 1984, p.45) and Solomons (1986, p.95) all offer support for the central role of information needs. In his 1982 study Barton develops in some detail the main information needs of users and the financial

4 See, for example, the article of G E Tibbits reviewing the case for an accounting court.
financial information may be but one of a series required for the creditor's decision whether to supply, or to continue to supply, goods or services on credit.

First, there are those that possess an obvious and direct relationship to financial information. For example, the need of a creditor or potential creditor for knowledge of the bank balance of an entity. This piece of financial information may be but one of a series required for the creditor's decision whether to supply, or to continue to supply, goods or services on credit.

Secondly, there are information needs which require more than one piece of information but without calling for a full set of financial statements. Suppose, for example, that the creditor required details of the previous period's cash receipts and payments to assist in estimating the likely cash balance at the end of the current period. Like the first example the need itself is clear, and the information relevant to that need is likewise clear.

Thirdly, and in sharp contrast to the first two, there are information needs for which a full set of financial statements is required. The relationship of these latter information needs to the accounting information is usually less direct, particularly when expressed in general terms, like stewardship or capital maintenance. In order for these general terms to be capable of conferring meaning on the primitive terms of the double entry calculus they must themselves first be given specific meaning. Once this is done, that meaning "flows" through the double entry calculus. As stated by Barton "the measurement method must be implicit in the definition [of the relevant concepts] for it to be operational" (1982, p.66).
Consider capital maintenance. Depending on the user's information need, it may mean maintenance of money capital, purchasing power capital or operating capability "capital". Each concept of capital dictates its own unique interpretation of the double entry calculus, including detailed rules for measurement of profit. Suppose the information need is that of a shareholder for information on profits legally available for dividend, then the relevant concept of capital is the money share capital contributed by shareholders. However, if the shareholder wished to know whether the purchasing power of the contributed share capital had been maintained, then purchasing power capital would be the relevant concept.

Thus, in each case the user's information need must be expressed in terms that are sufficiently specific to determine the relevant concept of capital and the unit of measure. Providing information relevant to capital maintenance requires a fully articulated set of financial statements clearly relating profits, dividends and the paid-up share capital.

In comparing these three types of information needs a further complexity becomes apparent. Whereas the first two information needs required only one quantity to be measured (i.e. the amount of cash or cash flow), the application of the double entry calculus may call for the measurement and disclosure of any one of several quantities of an asset, for example, its cost, NRV or future net revenue. The concept of capital is the unifying agent bringing these three measurement bases into a common relationship.

Because of the emphasis of information needs, the impression may have been conveyed that it is believed that each and every information need of individual investors and creditors should be met. But such a broad and open-ended approach is not supported. For the purposes of external financial reporting the main information needs are those relevant to a class or group to which the entity has a clear responsibility to report.
Even so, Barton (1982, p.68) lists eight "wealth and income measurement systems".

The secondary qualities previously enumerated will now be discussed. They are designed to ensure that the reality being measured (i.e. the particular concept of capital and profit, and the quantity of assets and liabilities) is properly communicated to users in financial statements.

Completeness means that the accounting information communicated should be full and complete in itself, including disclosure of all material amounts and sub-totals. The information disclosed must be placed in context to prevent misinterpretation. Clearly disclosing the particular concept of capital being measured and directors' accounting policies is important for this purpose. Synonyms conveying a meaning similar to completeness are fullness, adequacy and sufficiency. Were the accounting information provided incomplete or insufficient then the message conveyed could be false or misleading. It is interesting to note that s.272(1) refers to the provision of "sufficient information" to directors, in relation to subsidiaries, to ensure that neither their statement nor the report will be "false or misleading in a material particular".

Materiality acts as a sieve, eliminating unnecessary detail and enabling the accounting statements to be simplified and the relevant information highlighted.

Propriety of presentation is a "catch-all" phrase to embrace all aspects of the proper presentation of the accounting information not included in the qualities already discussed. In addition to those qualities correctness, clarity and conciseness in the use of technical terms and descriptions are also required for clear and unambiguous communication in accounting reports.
Timeliness is also a quality affecting the relevance of information. Although properly measured and presented, accounting information reported after the relevant decisions had been taken would no longer be relevant.

The application of the primary and secondary qualities of fair to accounting practice is summarised hereunder.

Summary of the interpretation of fair

<table>
<thead>
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<th>Primary quality</th>
<th>Financial statements</th>
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<tbody>
<tr>
<td><strong>Relevance:</strong></td>
<td><strong>Selection of accounting information to be disclosed from output of the relevant model:</strong></td>
</tr>
<tr>
<td>Information need---(Capital; (Unit of measure)</td>
<td>Measurements of assets, liabilities, profit, owners equity, etc.</td>
</tr>
<tr>
<td>(Interpretation of the double entry calculus)</td>
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**Secondary qualities**

| Completeness, materiality --------------| Display or presentation of that information in financial statements; and |
| Propriety of presentation --------------| Communication to users within the time frame for the relevant decisions, or accountability. |
| Timeliness --------------------------| VI. "Present fairly" |

The meaning of the phrase "present fairly" used in American audit reports is of immediate interest here in Australia. The Auditing Standards Board (AuSB) believes that the replacement of "true and fair view" with "present fairly the state of affairs of ... at ... and the profit for the year then ended in accordance with Australian Accounting Standards" will improve the effectiveness of audit reporting.
There appear to be three possible ways, or combinations of them, in which present fairly may be interpreted. First, that the accounting information to be communicated in financial statements is fully, adequately and properly set out so as to convey the intended message. Secondly, that the accounting information has been presented in accordance with accounting principles. Thirdly, that the accounting information is appropriate or relevant to its intended or assumed use.

The first interpretation is clearly embraced by the secondary qualities discussed previously. It is concerned with effective communication.

The second raises the very real question of whether "present fairly" represents a criterion independent of accounting principles or standards. If not, then as Professor Walker has claimed, the AuSB's approach "amounts to the virtual abandonment of an overriding requirement concerning the quality of financial reporting" (as quoted by Tony Thomas, p.109).

Such an approach would appear to be contrary to the intent of s.269(8B) in imposing an overriding requirement. Furthermore, it effectively renders the use of "fairly" redundant. In other words if the second meaning was the meaning intended then the audit opinion preferred by the AuSB would be better amended to read "present the state of affairs of ... as at ... and profit for the year then ended in accordance with Australian Accounting Standards". Clearly this approach is limiting.

The third approach transcends accounting principles, involving an expression of opinion whether the accounting information is relevant to the intended or assumed information needs of the users: information is presented fairly, or is fair if it is satisfactory for the user's purposes. This is the substantive meaning for which I have used relevant. It calls for identification of the users and their information needs. Of course, all three approaches could be combined in the one requirement.
With these distinctions in mind it is appropriate to consider American practice and views.

The application and scope of the expression "present fairly in conformity with generally accepted accounting principles" in the American independent auditor's report is explained in the Auditing Standards Board's Omnibus Statement on Auditing Standards of August 1982. Paragraph 5 sets out the sources of authority and pronouncements comprising the body of "generally accepted accounting principles". The following extract from paragraph 6 indicates their application.

Rule 203 provides that an auditor should not express an unqualified opinion if the financial statements contain a material departure from such pronouncements unless, due to unusual circumstances, adherence to the pronouncement would make the statements misleading. Rule 203 implies that application of officially established accounting principles almost always results in the fair presentation of financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles. Interpretation 203-1 of the AICPA Code of Professional Ethics states, "There is a strong presumption that adherence to officially established accounting principles would in nearly all instances result in financial statements that are not misleading." Nevertheless, rule 203 provides for the possibility that literal application of such a pronouncement might, in unusual circumstances, result in misleading financial statements.

From this it appears that:

(i) there is a presumption that normally the application of accepted accounting principles will result in "fair presentation";

(ii) the presumption is open to rebuttal;

(iii) therefore, there is a higher principle that may override accounting principles; and

(iv) that principle is that the financial information should "not be misleading".
American writing, concerned to ensure that accounting should remain neutral as between competing interests in society, has valued fairness highly. Fairness in accounting was framed by DR Scott in 1941 in terms of accounting's rules and procedures not being used to serve a special interest. Leonard Spacek developed the concept in his address on the need for an accounting court to the 1957 AAA Convention:

An accounting principle to be of utility to consumer, labor, stockholder and management would require support in each pronouncement as to why the principle adopted produces a fair result from the standpoint of each of these segments of society (p.35).

In his comments on The Basic Postulates of Accounting Spacek presented a sharper interpretation, stating:

... the one basic accounting postulate underlying accounting principles may be stated as that of fairness - fairness to all segments of the business community (management, labor, stockholders, creditors, customers and the public), determined and measured in the light of the economic and political environment and the modes of thought and customs of all segments - to the end that the accounting principles based upon this postulate shall produce financial accounting for the lawfully established economic rights and interests that is fair to all segments (Moonitz, 1961, p.57).

Fairness, under this interpretation, becomes the basic postulate against which all others are assessed.

Professor M. Moonitz, in rejecting Scott's concepts of justice, truth and fairness, nevertheless endorsed the view expressed in Accounting Research Bulletin No.43 that the "results must be judged from the standpoint of society as a whole - not merely from that of any one group of interested persons" (1961, p.5). His emphasis clearly implies a concept of fairness similar to Spacek's. Tibbits suggested "fairness as between competing interest groups" (p.119) as one of the criteria to be applied by an accounting court.

Yet several major difficulties raise doubts about the possibility of applying this approach.
First, with respect to the view expressed in ARB No. 43, how is a judgment to be reached that the results are fair to "society as a whole"? How is this going to be measured?

Secondly, following Spacek's approach, what is the basis for a judgment whether given accounting information is indeed "fair to all segments"? Spacek had stressed in 1957 that for "an accounting principle to be of utility to consumer, labor, stockholder and management would require support in each pronouncement as to why the principle adopted produces a fair result from the standpoint of each of these segments of society" (p.35). In emphasising a fair result from the standpoint of each of the segments of society, the quote appears to be supporting an approach that recognises that the information should be related to the information needs of each group. Great difficulty is envisaged in ensuring that financial information was fair in respect of "the lawfully established economic rights and interests" of each segment, particularly labor and stockholders, and simultaneously fair to the rights of all segments in toto.

Undoubtedly accounting would lose any claim as an objective measurement discipline were the measurements reported in financial statements biased in favour of a particular group. Profit should be measured properly in accordance with the rules of the relevant model. It is significant that the FASB's definition of neutrality reading

Absence in reported information of bias intended to attain a predetermined result or to induce a particular mode of behaviour (SFAC No. 2, p.xvi)

is framed in terms of what might be described as the absence of flagrant bias. The discussion of SFAC No.2 does, however, outline a positive aspect of neutrality which is entirely in accordance with the views advanced in this article. Consider the following two quotes:

Neutrality means that either in formulating or implementing standards, the primary concern should be the relevance and reliability of the information that results, not the effect that the new rule may have on a particular interest.
To say that information should be free from bias towards a predetermined result is not to say that standard setters or providers of information should not have purpose in mind for financial reporting. Of course, information must be purposeful. But a predetermined purpose should not imply a predetermined result. For one thing, the purpose may be to serve many different information users who have diverse interests, and no one predetermined result is likely to suit them all.

The concept of fairness to one and all is too broad. A "user-specific" approach is needed to overcome its weaknesses. The overriding concept of "not being misleading" drawn from American practice, while relevant as a communication criterion, does not appear to qualify as a fundamental criterion governing what should be reported. It, too, must be interpreted in order for it to be applied.

The Spacek concept of fairness is consistent with the equally long standing American view that financial reporting is "general purpose financial reporting" (SFAC No.1, p.14). This is the rock on which I believe the FASB's conceptual framework foundered. The weakness of the general purpose view is that it effectively precludes the development of "different concepts of capital for different purposes".

VII. Interpretation of "a true and fair view"; a summary

I believe that bringing together the interpretations proposed for truth and fairness provides a sound prescription of the statutory standard. At the broad, philosophical level "true and fair" may be equated to "relevance and reliability", meaning that the accounting information should be relevant to recognised information needs of users; that it should be empirically and analytically valid; and that it should be properly communicated. This is the unchanging, constant, general meaning of true and fair. However, as information needs change then the "content" or interpretation of that meaning changes. Thus it is not a static concept.
Moreover, change could extend to replacement of the double entry calculus if a more relevant structure for processing accounting information was accepted. Bearing in mind that Barton outlined eight models the question of selecting the relevant model is far from being trivial or obvious.

The position reached is now summarised. The opportunity is also taken to demonstrate how the ideas would be applied, and this has determined the order of listing.

### Meaning of the concept

**FAIR** (primary quality-relevant): that the measurements reported in financial statements are suitable for the recognised information needs of users.

**TRUE:** that the measurements reported in financial statements have a one-to-one correspondence with:

1. the interpretation of the double entry calculus being applied in order to measure particular capital/profit concepts (analytical validity);
2. the quantity of assets and liabilities and changes in them being measured in accordance with (a) (empirical correspondence).

**FAIR** (secondary qualities): that the measurements reported in financial statements communicate the reality being measured, utilising the secondary qualities of completeness, materiality, propriety of presentation and timeliness.

### Application

1. Decide the information needs of users to be satisfied by annual financial statements.
2. Select for each recognised need the specific concept of capital and the unit of measure.
3. Record and process the transactions of the entity, utilising the unit of measure identified in (2); and using rules from the specific model (interpretation of the double entry calculus) designed to measure the capital concept derived in (2).
4. At the close of the period, utilising the above concepts, prepare the financial statements.
5. Present the accounting information in financial statements to users in accordance with the secondary qualities.

Applying these steps should ensure that the overall results and amounts reported in the financial statements are empirically and analytically valid in relation to the information needs or purposes for which they were relevant; and that the profit statement and the balance sheet give a true and fair view of profit for the period and of the state of affairs at the period end.
It will be appreciated that, were this approach accepted, steps 1 and 2 should be decided by the community after a period of debate through the ASRB.

VIII. Application to four information needs

I will now demonstrate, by way of example, the application of the first two steps. Relevance as the primary concept of fairness requires the identification of both the users and their information needs.

Before proceeding, a caveat should be entered. For the purpose of demonstrating the application of this concept of fairness, shareholders have been selected as an example of a user group in relation to company annual accounts, and four of their information needs identified. I believe that these information needs are relevant today. A full discussion of all information needs for which annual financial statements might be expected to provide relevant accounting information would require consideration of the rights of creditors and other parties who rely on the accounts. Consideration of these and other information needs is beyond the scope of this paper. However, it needs to be appreciated that the outcome of a full examination may be that different applications of the double entry calculus with their related sets of financial statements are required.

5 See, for example, Baxt's discussion of the 1976 Walker v Wimborne Australian High Court case in which Mason J. in discussing the duties of directors "recognised that directors in acting and considering what course of action might be taken should take into account not only the interests of shareholders, but the interests of creditors as well" (1977, p.199). The New Zealand Court of Appeal case, Scott Group Ltd. v. McFarlane and Others, is "seen as a trend in the development of the law of negligence in this area towards an enlargement of the class of persons to whom an accountant, in the preparation of his accounts, might be liable in damages on a claim based on negligence" (D.F. Donovan, 1978, p.4). But, as suggested on page five, it should be possible to distinguish a responsibility to report to a particular group from a general responsibility of care.
The accounting information disclosed in financial statements should be fair to shareholders, being members of the company to whom the directors and auditors have a statutory obligation to report. Furthermore, it is the shareholders as a class or group, implying that the information needs are group information needs common to all shareholders. Such needs should be able to be objectively agreed, ruling out a subjective interpretation and thus also dispelling any possibility of framing an answer in terms of "special interests", a danger noted by Moonitz (1961, p.4).

Four information needs of shareholders are presented here as information needs that should be satisfied today by the annual financial statements of directors. Following a brief outline of each, their relationship to the measurements reported in financial statements is discussed.

The information needs are:

1. **Capital maintenance**

   The need of shareholders for financial statements disclosing the annual profits legally available for dividend, retained profits and the amount and form of paid-up share capital.

2. **Stewardship**

   The need of shareholders for financial statements disclosing the results achieved by directors from their use of the funds entrusted to them, and the present form and disposition of those funds, thereby also disclosing whether investments undertaken are in accordance with the objectives of the company.

3. **Liquidity**

   The need of shareholders for a report on the company's liquidity as an indication of its solvency, disclosing liabilities to be met in the short term, assets available to meet them, the rate of operating cash flow, the amount of any unexercised bank overdraft, and the amount and value of any guarantees or securities granted by other entities to secure the company's debts.

4. **Net realisable values**

   The need of shareholders for disclosure of the net realisable values of all assets in order that shareholders do not sell their
shares without such information where it was available to the company.

Under these interpretations of capital maintenance and stewardship both require measurement of periodic profit on the basis of results achieved from use of the funds invested in the business. The relevant concept of capital in relation to these two information needs is paid-up monetary share capital, and the unit of measure is money. The derived notion of profit is monetary profit. I have elaborated the arguments in favour of these relationships more fully in my 1982 article. This, the traditional concept of stewardship, is based on accountability of directors to shareholders for the money funds invested in the business. The case for current value information would necessitate a different interpretation of stewardship and thence the double entry calculus.

The need for a report on liquidity has not been directly recognised in the law or professional standards, although since 1983 the directors have been required to express an opinion whether, at the date of their statement, the company is able to pay its debts as they fall due. Liquidity is a short term concept which should be distinguished from solvency, which also includes the long term. Nevertheless, liquidity is an important information need which can largely\(^6\) be met within the framework of financial statements, including a funds statement, prepared in accordance with the monetary model. The funds statement, which by disclosing the investing and financing activities provides relevant information with respect to stewardship, may be arranged with a separate section dealing with short term funds and changes in them.\(^7\)

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6 The qualification relates to the fact that current assets are not shown at NRVs - yet that may well be the relevant property for measurement of liquidity. Consider, for example, temporary investments of surplus operating funds.

7 For my detailed suggestion on how this could be effected, see J.B. Ryan, March 1972. The evolution of the funds statement to the position where it virtually has become a required statement without legislative support is worthy of note. However, the replacement of the funds statement by a cash flow statement now appears imminent.
information could be disclosed by a change in balance sheet classification of current items.

The fourth information need is clearly of a different sort and provides a good example of an information need requiring a departure from a cost, or money flow, basis. Shareholders should be entitled to details of NRVs known to the company to ensure that they do not dispose of their shares without that information, particularly in the case of a takeover in which control may pass from directors elected by them.

However, the monetary model does not require disclosure as a matter of course of the NRVs of all assets, most notably of the fixed assets. Following rules for measurement of monetary profit they are shown at the lower of written down cost or recoverable amount, the latter being the higher of the future net revenues or the asset's NRV. So NRV is only used for fixed assets when it is less than cost and exceeds the expected future net revenues. Thus, it is unlikely to be regularly disclosed and should, therefore, be disclosed in the annual financial statements. Separate disclosure in a supplementary statement would facilitate calculation of NRV "asset backing" per share. Where there is no NRV available for a particular asset, the insured value should be disclosed.

NRVs can also be relevant with respect to assessment of liquidity and future prospects. Of two companies with similar earnings, assets and debt structure, the only difference relating to the type of investment in fixed assets, the company whose fixed assets are more readily convertible into cash without loss is less of a risk. Such a company also possesses improved adaptability.

Each of the four information needs, although considered briefly, has been elaborated sufficiently to demonstrate the logical relationship that should pertain between the information need and the quantity to be measured in each case.
Professional opinion

Accounting practice has been influenced greatly by the accounting standards issued by the professional bodies. But, prepared in the absence of agreement on objectives or a conceptual framework, the standards lack consistency. Accounting practice, once clearly based on concepts such as realisation and cost allocation, both fundamental to historical cost, has been modified so that its measurements are now a mixture of several different models.

My purpose in this part is twofold. First, to trace the evolution of the professional view from one relying largely on accounting recommendations and standards—described as a technical interpretation—to a more general interpretation. Secondly, to show that the so-called technical approach can be reconciled with a general, philosophical one.

Following the shock of the Royal Mail Case, the Institute of Chartered Accountants in England and Wales began issuing in 1942 recommendations on accounting principles, the forerunners of today's standards. This lead was followed by the Institute of Chartered Accountants in Australia. There is little doubt that these recommendations had a significant impact on accounting practice. The 1962 Jenkins Committee stated, for example, that:

The Recommendations on Accounting Principles periodically issued by the Institute of Chartered Accountants in England and Wales to their members have already done much to ensure that the standards of accounting are reasonably uniform and constantly rising. These recommendations are based on close and constant study of the relevant problems, which are ever changing, and 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 (p.131).

Following the recommendations and standards of the professional bodies has been viewed as applying a technical interpretation to the true and fair view statutory standard, this interpretation being seen as one opposed to giving the words their ordinary or popular meaning. Accountants have encouraged this interpretation, the late Sir Keith Yorston, a respected spokesman, stating in 1960 that:

The words "true and fair" as applied to financial reports mean true and fair from an accounting viewpoint. The financial report may be true from an accounting standard but not necessarily true in fact — for example, an asset may be purchased which is being depreciated each year and thus appears in the financial reports at a decreasing amount each year, when in fact the asset may, for special reasons, be actually increasing in realisable value. For example, a property may be purchased and because of special circumstances — shift in population, or new means of transport — may be worth as a realisable figure considerably more than its cost, at which cost figure, or less, it may show in the financial report. Accountants regard as "true and fair", at least from an accounting viewpoint, a financial report which shows the property mentioned at either its cost figure or at a lower figure because of depreciation provided. In other words, "true and fair" applying to a balance sheet merely indicate a true and fair view of where and how the funds of the enterprise have been obtained and where and how they have been invested and the amount so invested, and as regards the revenue statement they mean that the items of revenue and expenditure have been matched therein according to accepted accounting concepts (New Zealand Society of Accountants, Proceedings of Jubilee Convention, 1960, pp.107-108).

A lay person reading this statement could be excused for concluding that an "accounting viewpoint" was opposed to the "facts" (in the form of net realisable values). The sixth edition of Johnston, Jager and Taylor continues this dichotomy of possible interpretations by stating that:

The standard "true and fair" is very indefinite and broadly there are three ways in which the words can be interpreted

(a) literally, and in their ordinary or popular meaning, that is, without regard to possible technical interpretations;

(b) technically, and meaning in accordance with accounting principles either recommended by the leading accountancy bodies or followed in best practice; or
(c) technically, and meaning in accordance with accepted accounting or business practice which may in the extreme mean merely that "somebody has tried it" (p.263).

A literal interpretation utilising accounting concepts and techniques is simply not envisaged as a possibility. Indeed, it is specifically ruled out by (a). However, it would appear impossible to measure periodic profit of any public company without resort to technical rules, particularly in today's complex business environment. All professions have a technical side which is unlikely to be fully comprehended by the layperson, but that ought not to mean that the essence of what is being done cannot be communicated in ordinary language understandable to the layperson.

As might have been expected, reliance on the so-called technical interpretation was roundly criticised, most notably by lawyers. But the debate was widened when Mr. F.J.O. Ryan, Commissioner of Corporate Affairs in NSW, stated in 1974 that he had come to the conclusion -

that in selecting the phrase "true and fair" as the standard by which the profit or loss of a company and the state of its affairs are to be judged the Legislature in effect conferred a legislative function on the accountancy profession. It is a legislative function of an ambulatory nature: what is "true and fair" at any particular point of time will correspond with what professional accountants as a body conceive to be proper accounting principles. The evolution, development and general acceptance of those principles will cause the concept of what is "true and fair" to shift accordingly (p.15).

Understanding was further assisted by a legal opinion obtained in 1978 by the NZ Society of Accountants, and reading in part:

In times of change the historical cost method might well be true in a literal sense without in any way producing a fair view.

9 See, for example, Baxt (1968), Gower (1969), Wallace (as quoted by F.J.O. Ryan (1967), and F.J.O. Ryan (1967).
We think that while the historical cost method remains the generally accepted method of preparing accounts, accountants and auditors can generally proceed on this basis. This would generally produce a true view. The question then remains whether this is also a fair view (p.34).

The opinion then drew attention to the fact that the 1973 New Zealand Macarthur Committee (similarly to the Eggleston Committee in Australia) had noted the view of the Jenkins Committee that "accounts prepared on the historical cost basis may need to be accompanied by supplementary information in order to give the shareholders the true and fair view required by the Act" (paragraph 334), and after further discussion concluded that:

The test of "true and fair" is not an absolute one but is flexible and must allow for some variation in the accounting procedures adopted and the manner of presentation. While a historical cost method if properly carried through will almost certainly be true and in most cases fair, the question of whether it is fair varies with the circumstances and must be specifically considered by those responsible in the particular circumstances (p.34).

The distinction drawn in the legal opinion between true and fair is consistent with the interpretations developed in this paper. Thus, HCA "properly carried through will almost certainly be true" but may not be fair. Fair "varies with the circumstances".

A similar interpretation of fair was offered by Mr. R.B. Jack when he referred to the need "... to ensure that the practices adopted are appropriate to the circumstances" (1977, p.102). The overriding "circumstance" referred to in these two instances would, undoubtedly, have been the high and continuing rate of inflation. Yet that is only one economic condition with which business has to contend. Furthermore, it affects different industries differently and, indeed, even in the absence
of a high rate of general inflation, significant changes may be taking place in the level of specific prices of particular industries.\textsuperscript{10}

It is submitted that the general question posed by the Jenkins Committee in respect of supplementary information can only be answered by first identifying the information needs annual accounts are expected to satisfy. Then, and only then, can the relevant accounting information be measured and disclosed. Perhaps it related to disclosure of NRVs as discussed in the fourth example of an information need.

The emergence of true and fair as a dynamic concept was given professional recognition in the legal opinion obtained by the UK Accounting Standards Committee (ASC) in 1983. The ASC published the opinion in full, noting that it "gains it weight from the quality of its argument". The ASC, "intends to take account of the opinion in all its future work" (Hoffman L. and M.H. Arden, p.154). The opinion is particularly relevant on the nature of the true and fair concept. It also explores the relationship between Statements of Standard Accounting Practice (SSAPs) and the law, although because of different legal requirements comments on the latter are not directly applicable here.

Regarding true and fair, the opinion emphasises that it is a legal concept and "the question whether company accounts comply ... can be authoritatively decided only by a court" (p.154). However, "it is an abstraction or philosophical concept expressed in simple English" (p.155). The authors go on to make several relevant points. First, that the law uses similar concepts "of which 'reasonable care' is perhaps the most familiar", noting that there is seldom difficulty in understanding what

\textsuperscript{10} Inflation does, of course, strike at the purchasing power of the monetary unit, the unit of account. I have argued elsewhere that there is no such thing as a constant or common unit of purchasing power that could be used as the unit of measure in accounts (1972).
they mean but controversy over their application to particular facts." A reason for this is the very high level of abstraction, which then has to be applied to an infinite variety of facts, with the result there will always be "a penumbral area in which views may reasonably differ."

Secondly, the authors of the opinion believe that the courts have been wise not to attempt to define the term, stating that "when a concept can be expressed in ordinary English words, we do not think that it illuminates their meaning to attempt to frame a definition", rather "it is much more useful to illustrate the concept in action, for example, to explain why certain accounts do or do not give a true and fair view." They doubt whether the man on the Clapham Omnibus would have much to offer accountants in the preparation of a set of accounts. Views could differ on this issue, depending on the type of definition attempted.

Thirdly, they stress that the application of the concept involves judgment in questions of degree. This is consistent with their view of a penumbral area in which views may reasonably differ. It is noteworthy, for later reference, that in discussing what is acceptable and its achievement they state that the "information contained in accounts must be accurate and comprehensive (to mention two of the most obvious elements which contribute to a true and fair view) ...".

They note, in addition, "there may sometimes be room for differences over the method to adopt ..." and "cases in which there may be more than one 'true and fair view' of the same financial position."

The final view of the authors I wish to draw attention to is that "the meaning of true and fair remains what it was in 1947. It is the content given to the concept which has changed." Thus while the central meaning remains unchanging its application may change over time to accommodate changes in the environment of accounting, including the issue and revision of accounting standards.
On the relationship of Statements of Standard Accounting Practice (SSAPs) to the true and fair view requirement stipulated in the UK Companies Act 1981 the authors first define a SSAP as follows:

A SSAP is therefore a declaration by the ASC, on behalf of its constituent professional bodies, that save in exceptional circumstances accounts which do not comply with the standard will not give a true and fair view (p.154).  

Accepting that in the final analysis whether accounts give a true and fair view must be decided by a judge, and that the courts will look to the practices of accountants for guidance, a SSAP that was accepted and applied would be of value to the court, first, as a statement of professional opinion and, secondly, because of the expectation that accounts so prepared will comply with prescribed standards. In this process, no conflict is seen between the functions of the ASC in formulating standards "which it declares to be essential to true and fair accounts, and the function of the courts in deciding whether accounts satisfy the law" (p.155).

The UK legal opinion offers substantial support at a general level for the position outlined in this paper. There is a coincidence of views that true and fair is a general philosophical concept possessing a constant general meaning, but one whose application may change to suit differing circumstances, and that there may be more than one true and fair view of the same financial position. My explanation demonstrates how this follows from different information needs of users, leading to the use of different concepts of capital, and thence profit.

11 This is similar to the view which Mr. F.J.O. Ryan came to accept as Commissioner of Corporate Affairs in NSW. The 1978 Report to the NSW Parliament included the statement that The Commission takes the view that non-compliance with the accounting standards promulgated by the Institute of Chartered Accountants in Australia and the Australian Society of Accountants is prima facie evidence that the accounts may not show a true and fair view (p.75).
One remaining matter is to relate accurate and comprehensive, described in the legal opinion as two of the "most obvious elements" contributing to a true and fair view, to my approach. Accuracy is obviously related to empirical correspondence between the quantity being measured and the amounts disclosed in financial statements: and comprehensive to completeness, one of the secondary qualities for communication.

X. Implications

The general implications for accounting, of accepting the interpretation of "true and fair" advocated in this paper, are that accounting standards should be revised, requiring reporting entities to be more specific in stipulating their general accounting policies, including the interpretation(s) of the double entry calculus being applied in each case. This would provide a basis for sharpening up the particular accounting policies and provide a "focus to the accounts" (Walker, 1986, p.35). The auditors' report should contain explicit reference to the accounting model applied in the financial statements in each case.

Dealing with changes at the institutional level first, the ASRB would need to review the policy statement of the 1983 NSCS Green Paper adopting the "general purpose" view of the objectives of financial reporting. The AARF should immediately revise AAS 6 Accounting Policies: Determination, Application and Disclosure to incorporate the new approach through which the information needs of users become the vehicle for conferring meaning on the primitive terms of the double entry calculus. Simultaneously these bodies should jointly initiate an intensive and wide ranging examination and debate, including empirical surveys, of the main information needs which should be satisfied today. Traditional needs like capital maintenance and stewardship need to be refined and sharpened in the manner indicated to enable the primitives to be derived from them. In addition, new needs
should be fully investigated, for example, whether NRVs of all assets should be separately disclosed and totalled as supplementary information. Research into new and emerging needs should be ongoing.

These ideas are not novel. AAS 6 calls for a statement of the general system underlying the financial statements, or each set of them. From 1974 to 1983 SSAP 1 Disclosure of Accounting Policies issued by the New Zealand Society of Accountants assumed that, unless stated otherwise, a set of general concepts set out in the Standard was being applied. On revision in 1983, the general presumption was dropped in favour of disclosure of the general principles of measurement without, however, extending to the concept of capital. All the 100 companies in the survey of New Zealand financial reporting disclosed their general accounting policies, including the measurement based. For the 1986 year 87 disclosed that they used HCA with revaluations while 13 disclosed the use of HCA (J.B. Ryan, 1987, p.14).

With the general approach in place individual standards should then be reviewed to reflect it. Inconsistencies in standards purportedly applying the same model should be eliminated. The lead of the International Standards Committee in 1972 when it specified the model in the heading of IAS 2 Valuation of Inventories in the context of the Historical Cost System could be extended to all standards.

Without waiting for the completion of this review directors and financial controllers could immediately expand their statement of the general system underlying financial statements to include the main information needs, concepts of capital (and profit), and the unit of measure. Particular accounting policies would, of course, then need to be consistent with those concepts. They would have an important contribution to the overall debate, ensuring that new ideas were properly examined, and tested for their practicality and cost effectiveness.
Auditors have painstakingly promulgated standard forms of the audit report, and their revision should be undertaken with extreme care, especially to ensure that relating the expression of opinion to a particular model was not viewed as a qualification.

Charles Carslaw recently drew attention to the view of the late Horace Tilly that the intention of the auditor in referring to a particular model was to inform the reader what the auditor had interpreted profit to be, and not to qualify the accounts. He quoted the following from Tilly:

The Act does NOT say that the accounts must be true and fair. full stop. That would be an absolute. What the Act says is that the accounts must give a true and fair view of profit and a true and fair view of the state of affairs. The words I show in italics have purpose and meaning and should not be ignored. They reveal a considerably more modest requirement.

If the interpretation of these sections forms the reason for an approach to the courts, may it not well be that the case will turn not on what is the meaning of "true and fair" but on what is the meaning of the word "profit". What concept of "capital" lies behind it? Now, the Companies Act does not define "profit" and there is nothing like a commonly accepted meaning of the word in the marketplace and the accounting profession and the legal profession (p.45).

Adapting Carslaw's suggested amendment the audit report, in abbreviated form, should then read:

The financial statements have been properly drawn up so as to give a true and fair view of profit and the state of affairs under the historical cost system (monetary model).

If more than one set of financial statements were presented, then the audit report should refer to each separately.

Application of this approach should result in an integrated set of financial statements for which the concepts of capital and profit being measured were stated explicitly, in turn leading to a consistent set of figures for each model utilised. Advantages would also accrue from explicit recognition of the measurement base for each model. Such clarity, and implementation, of the basic measurement concepts would lead to improved communication in financial statements, and understanding of them.
APPENDIX A
THE DOUBLE ENTRY CALCULUS

(or the general external financial reporting model for periodic capital/profit measurement)

Elements of the system and symbols representing them:

- A = Assets
- L = Liabilities
- OE = Owners equity
- C = Capital contributed by the owners
- D = Dividends or withdrawals by the owners
- P = Profit
- R = Revenue
- E = Expense
- RP = Retained profits
- $\beta$ = Unit of measure

Dating Conventions

(i) Unbracketed subscripts denote the net amount of an element at the point of time shown.

(ii) Bracketed subscripts denote the net change in an element occurring during the period ending at the time shown. Thus,

$$\Delta OE_t = \Delta OE_t - \Delta OE_{t-1}$$

Primitive elements

Capital, unit of measure.

Defined elements

Once specific meaning is conferred on the primitive elements, meaning will then flow from the axioms to the remainder of the elements.

Formal definitions

$$\Delta OE_t = \beta C_t + \Delta RP_t$$
$$\Delta RP_t = \Delta RP_{t-1} + \beta R(t) - \beta D(t)$$
$$\Delta OE(t) = \beta C(t) + \beta R(t) - \beta D(t)$$

Axiom

(1) $\Delta OE_t = \beta A_t - \beta L_t$

Derived relationship

(2) $\Delta OE(t) = \beta A(t) - \beta L(t)$
Substituting for $\beta OE(t)$ into (2):

\[ (3) \quad \beta P(t) = \beta A(t) - \beta L(t) - (\beta C(t) - \beta D(t)) = \beta R(t) - \beta E(t) \]

**Further derived relationship**

Substituting for $\beta OE(t)$ and $\beta RP_t$ into (1):

\[ (4) \quad \beta RP_{t-1} + \beta P(t) - \beta D(t) = \beta A_t - \beta L_t - \beta C_t \]

**Capital maintenance rule**

For capital to be maintained, that is, not returned to shareholders under the guise of a dividend, then equation (4) should not result, overall, in a negative amount, meaning that net assets after payment of the dividend should not be less than the capital. So from (4):

\[ (5) \quad \beta RP_{t-1} + \beta P(t) - \beta D(t) \geq 0 \]

or

\[ \beta RP_{t-1} + \beta P(t) \geq \beta D(t) \]

**Capital maintenance theorem**

From (4) and (5):

\[ (6) \quad \beta A_t - \beta L_t - \beta C_t \geq 0 \]

or

\[ \beta A_t - \beta L_t \geq \beta C_t \]
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