

WORKING PAPER

SPANISH AUDITORS AND THE 'TRUE AND FAIR VIEW'

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Abstract

In 1990 a new Spanish 'Plan General de Contabilidad' (PGC) implemented the requirements of the EU 4th and 7th Directives in Spain. Included in the PGC is the requirement, derived from the 4th Directive, that accounts should present a 'true and fair view', in Spanish 'imagen fiel'. Where the term has been used in English speaking jurisdictions it has proved to have a variety of shades of meaning, and to have had strikingly different impact in different countries. Within the European Union the term has been seen as a 'Trojan horse', inserted into the 4th Directive to inject an Anglo-Saxon approach of flexibility and judgement dependent accounting into a Continental European accounting tradition of detailed prescription and uniformity. In this paper we report on a survey of the views and experience of Spanish auditors relating to 'imagen fiel'. Specifically, we:

- 1) Review the English language literature on 'true and fair view' to identify the key areas of controversy.
- 2) Consider the significance of the 'true and fair view' within the EU 4th Directive.
- 3) Report on the experience of Spanish auditors in working with this concept, their views on the value of the term, and their experience in use of the true and fair view 'override'.

Keywords: auditing, true and fair view, 4th European Directive

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1. Introduction

In 1990 a new Spanish 'Plan General de Contabilidad' (PGC) implemented the requirements of the EU 4th and 7th Directives in Spain. Included in the PGC is the requirement, derived from the 4th Directive, that accounts should present a 'true and fair view', in Spanish 'imagen fiel'. Where the term has been used in English speaking jurisdictions it has proved to have a variety of shades of meaning, and to have had strikingly different impact in different countries. Within the European Union the term has been seen as a 'Trojan horse', inserted into the 4th Directive to inject an Anglo-Saxon approach of flexibility and judgement dependent accounting into a Continental European accounting tradition of detailed prescription and uniformity. In this paper we report on a survey of the views and experience of Spanish auditors relating to 'imagen fiel'. Specifically we:

1. Review the English language literature on 'true and fair view' to identify the key areas of controversy.
2. Consider the significance of the 'true and fair view' within the EU 4th Directive.
3. Report on the experience of Spanish auditors in working with this concept, their views on the value of the term, and their experience in use of the true and fair view 'override'.

1. Interpretations of 'true and fair' view

Although the term a 'true and fair view' has been at the heart of the U.K.'s company law accounting requirements since 1947, no explanation of its meaning has been offered in company law in the U.K., the Commonwealth, or the European Union. Gill (1983, 703) argues that this lack of guidance may be beneficial:

"It is apparent that legislation provides very little guidance as to the meaning of 'true and fair...' The accounting and auditing environment is always changing and a prescriptive approach to the term would mean a preconceived view of changing circumstances".

Flint (1982, 8) argues that, since at that time company directors and auditors had over 30 years experience of applying the 'true and fair view' requirement, "there must be some general understanding of what is required, although it is not explicitly recorded". The challenge to express just what this 'understanding' consists of apparently proved too

much for three of the U.K.'s leading accountants: "Most tellingly, a television broadcast in 1992 included interviews with senior British accounting: when asked to define the 'true and fair view' one (partner in Ernst & Young) started to laugh, another (senior partner of a major non big-6 firm) would say nothing and the third, the finance director of an Anglo-American multinational, asked for time to think about the question" (Walton 1993, 49-50).

Horrocks (1967) describes the 'true and fair view' as "a technical term which is interpreted in several different ways".

The mostly widely cited definition, by Lee (1981, 270), contains a number of elements: "Today, 'true and fair view' has become a term of art. It is generally understood to mean a presentation of accounts, drawn up according to accepted accounting principles, using accurate figures as far as possible, and reasonable estimates otherwise: and arranging them so as to show, within the limits of accounting practice, as objective a picture as possible, free from wilful bias, distortion, manipulation, or concealment of material facts. In other words, the spirit as well as the letter, of the law must be observed".

Within this definition Higson and Blake (1993) find four distinct elements:

1) One element is an acceptance of a reasonable limitation on the degree of precision that the accountant can achieve, expressed in Lee's definition by reference to 'reasonable' estimates and acceptance of the 'limits of current accounting practice'. The introduction of the 'true and fair view' requirement in 1947 replaced a previous 'true and correct view' requirement. The change was advocated by the U.K.'s largest professional accountancy body, the Institute of Chartered Accountants in England and Wales.

"The word 'correct' has always been too strong because it implies that there is one view which is 'correct' as against all others which are incorrect. In published accounts there is no standard of absolute truth and the Institute's suggested amendment would recognise that the presentation of figures can only be that which is, in the personal view of the auditor, a fair view."

McMonnies (1967) supports this interpretation, observing: "Fair is possible in a way that the 'correct' of the 1929 audit report never was."

2) A second element is the implication of a 'substance over form' requirement. Lee's references to freedom from 'concealment of material facts' and observing 'the spirit as

well as the letter of the law' embraces this aspect. Lord Benson, one of the U.K.'s leading accountants, observes:

“Before the 1948 Act came into force it was not unusual for accountants to say “Well, it is on the right side”. In short, provided that the accounts as presented to the shareholders and the public showed a worse position than was in fact the case they could be accepted... The 1948 Act changed the whole situation. It required that the accounts should be ‘true and fair’. This meant that the doctrine of ‘correctness’ or ‘is it on the right side’ went out of the window. In effect substance took precedence over form” (Benson, 1989, 45).

Some authorities see the word ‘true’ as implying literal description while ‘fair’ implies the obligation not to mislead (e.g. Cowan, 1965).

Other authorities argue that the words ‘true and fair’ should be taken together, not separately. Thus Parker (1994, 17) argues:

“The form of wording ‘true and fair’ has led to separate discussions as to what is meant by ‘truth’ and ‘fairness’, which could have been avoided if ‘true and fair’ had been treated as hendiadys i.e. the expression of a complex idea by two words coupled with ‘and’”.

3) A third element in the notion of the ‘true and fair view’ is identified by Lee’s reference to “as objective a picture as possible, free from wilful bias”. The concept of “freedom from bias”, also known as neutrality is implied in the earliest discussions of accounting conventions, such as American Accounting Association (1966, 7).

“The concept has two aspects, firstly, that in presenting accounts there should be no attempt to manipulate users towards a particular conclusion, and secondly, that all segments of the user community should be equally well served”.

4) A fourth element in Lee’s definition is the reference to “accounts drawn up according to accepted accounting principles”. This aspect arises not so much from the specific wording in the ‘true and fair view’ requirement as from the very existence of a broad based requirement of this type within the law; since specific legal accounting requirements are deemed to require supplementing by this additional injunction, some additional authority must be looked to.

Irish (1966) argued that the words 'true and fair' implied that "the accounts follow the rules appropriate to this case". The U.K. courts have also considered how to interpret the 'true and fair' concept. In the case of *Re Press Caps Ltd* (1949, ch. 434) a shareholder challenged the validity of a balance sheet where freehold property valued at £90,000 had been shown at cost less depreciation of £30,000. The Court of Appeal rejected the challenge. In doing so Lord Justice Somervell observed that the accounting treatment was "in accordance with what is very common practice". The judgement is frequently cited as an indication that a 'true and fair view' can be achieved by following normal accounting principles. However, Williams (1985) points out that the other two judges of the Court of Appeal decided the case on other grounds.

A number of authorities in the U.K. have argued that Statements of Standard Accounting Practice (SSAPs) are a strong indicator of best professional practice and, therefore, compliance is likely to ensure a 'true and fair view'. Sherrard (1981, 132) considered that:

"The persuasive power of the standards will, I am sure, be seen to be greatly enhanced by the process by which they have been produced. They do, after all, represent the consensus opinions and recommendations of the accounting profession."

One company law textbook (Mayson et al. 1989, 218) offered the observation that: "If a court ever had to decide whether a set of accounts gave a 'true and fair view' it is difficult to see what other criteria could be applied than whether the accounts are drawn up in accordance with the considered practice of accountants generally".

An interesting insight into the way in which the 'true and fair view' requirement may be applied has been put forward by the present chairman of the U.K. Accounting Standards Board (ASB) (Tweedie, 1988). He argues that the 'true and fair view' requirement can be applied in two ways. In a "progressive" form it gives authority to "set aside archaic practices and to introduce more realistic policies". By contrast in the "regressive" form auditors "are constrained by the acceptance of prevailing practice by their colleagues" (Tweedie, 1988, 2).

The European dimension

The European Community's Fourth Directive on company law, issued on 25th July 1978, has been described as the "Kingpin of accounting harmonisation within the community" (Van Hulle, 1990, 5). Article 2 of this Directive includes the following paragraphs:

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

4. Where the application of the provisions of this Directive would not be sufficient to give a 'true and fair view' within the meaning of paragraph 3. Any such departure must be disclosed in the notes on the accounts together with an explanation of the reasons for it and a statement of its effects on the assets, liabilities, financial position and profit or loss. The Member States may define the exception rules in question and lay down the relevant special rules.

By contrast, the first draft of the Directive, published in 1971, contained no reference to the true and fair concept. The second draft in 1974 referred to it only in one paragraph similar to paragraph 3 of Article 2 of the published Directive; it did not include the requirements for extra information and a possible override of specific rules as laid down in paragraphs 4 and 5 of the published Directive.

Not surprisingly, the introduction of the 'true and fair view' requirement was very much a U.K. initiative. It responded to a fear in the U.K. on the part of British accountants that:

"... the Directive, if implemented, in its present form, would discount the importance which we, in Britain, attach to the 'true and fair view' provisions of British legislation, which leaves room for the necessary flexibility in preparing and reporting upon company accounts" (Stamp, 1973, 14).

The amendment of the second draft was perceived as:

"a most important change weakening as it does the original prescriptive approach of the first draft" (Burnett, 1976, 29).

Thus the 'true and fair view' requirement was intended by the U.K. to be a tool to resist a change in the philosophy underlying accounting rules. The present head of the U.K. Accounting Standards Board has observed:

"With the entry of the U.K. and Ireland into the EEC, the draft Directive underwent a major change with the introduction of both the concept of the 'true and fair view' and

greater flexibility in presentation. Without these major amendments, financial reporting in the U.K. would have undergone fundamental changes in both philosophy and style. Nevertheless the Fourth Directive has left accounting in the U.K. with a legacy of continental practice which threatens to put a brake on constructive development in financial reporting, and which could result in U.K. reporting methods diverging markedly from practice in the rest of the English-speaking world” (Tweedie, 1983, 112).

Indeed Hopwood (1990, 84-85) suggests that the debate over the first draft of the Directive kindled (perhaps for the first time) within the U.K. accounting profession an active interest in, and support for, the concept of the ‘true and fair view’. Only when British accounting practice was seen to be threatened by practices characterised by the legalistic German approach to accounting, did the U.K. profession rally to defend a phrase which, according to Hopwood, had had for many years a “rather lowly if not insignificant ritualistic role”. The dawning recognition of the phrase as embodying a defining philosophical approach to accounting in the U.K. may have been convenient at a time when the profession in the U.K. was struggling to rationalise its laissez faire attitude towards professional regulation.

A problem of harmonisation within the member states of the EU is that the legal application of the ‘true and fair view’ is subject to some variation. While all the states have complied with the requirement that annual accounts should present a ‘true and fair view’, Germany does not require, or even permit, departure from the detailed requirements of the law to give a ‘true and fair view’. The official explanatory note to the draft German law applying the true and fair concept observed, “In spite of the pretentious formulation it is supposed that for practice there will be no principal changes” (cited in Busse van Colbe, 1984, 123). However, the actual application of the override by businesses may not be so significant in practice. Van Hulle (1993, 102-103) notes with some surprise the evidence that few companies in the EU have availed themselves of the opportunity to use the true and fair override. In the FEE survey quoted by Van Hulle (FEE, 1992, 54) only 10 companies had employed the override. It may be, as Burlaud (1993, 98) suggests, that “very few companies would take the risk of departing from the accounting rules and justifying this by the extremely vague notion of the ‘true and fair view’”.

In Spain we find discussions of the significance of ‘imagen fiel’ developing from the mid 1980’s, in anticipation of Spain implementing EU directives. The term is ‘impossible to define’ (Niño 1992 p. 610 - our translation) and this is seen as ‘its most fundamental and

essential aspect' (Tua 1985 p. 45 - our translation). Amat et al. 1997 see two interpretations of 'imagen fiel' in the literature.

1) The 'legalistic' approach, that 'imagen fiel' is achieved by rigorous compliance with the law. Gondra (1991) offers a justification of this view.

2) The 'economic' approach, that 'imagen fiel' signifies an aspiration to portray economic reality. Thus Tua (1985) explicitly argues that 'imagen fiel' implies something above compliance with the specific rules, while Gonzalo et al. (1985) see 'imagen fiel' as representing substance over form. This second approach is seen by Amat et al. as the dominant theme in the Spanish literature on 'imagen fiel'.

Vallverdú and Castillo (1991) see the override as giving the professional accountant 'the last word' (p. 87 - our translation). As in the English language literature, some Spanish authors have raised the question as to whether historic cost accounting can truly give 'imagen fiel' (see for example Goxens (1990), Giner (1989)). Use of the override in Spain has not in practice been extensive; in a survey of 74 Spanish companies Navarro (1975) found it used just twice.

Views and experience of Spanish auditors

A postal questionnaire was sent to 100 auditors in practice. A total of 38 usable replies were received. This is comparable with the response rate to a similar questionnaire in Australia of 40% (see Deegan et al. 1994) and is a high response rate for Spain, where a more common rate would be 15.3% (see Garcia Benau et al. 1993).

As we have seen above, one implication of a 'true and fair view' requirement can be to add authority to the pronouncement of the professional accounting bodies.

Table 1 shows that 76% of respondents saw compliance with the recommendations of AECA as necessary in order to provide 'imagen fiel'.

This is in line with a study by AECA showing that 80% of Spanish auditors advise clients to follow AECA recommendations (Gabas 1991, p. 18).

Table 1

Is compliance with the recommendations of AECA necessary in order to provide 'imagen fiel'

	Number	%
YES	29	76
NO	9	24
	<hr/> 38	<hr/> 100
	<hr/> <hr/>	<hr/> <hr/>

We asked whether respondents had ever been asked by clients to consider using the 'imagen fiel' override. Table 2 shows that while 47% had never had this proposition put to them, 29% had received the suggestion more than 5 times. Table 3 shows that, where auditors have received such an approach, in 50% of cases they have always rejected it and in another 20% of cases have sometimes rejected it. In Table 4 we compare our findings in Spain with the finding of Parker and Nobes (1991) in the UK, where auditors appear to have experienced more client pressure to invoke the 'true and fair' override.

Table 2

How many clients have asked you to consider an override of specific accounting rules in order to achieve 'imagen fiel'?

	Number	%
0	18	47
1	5	13
2	3	8
3	1	3
4	0	0
5	0	0
more than 5	11	29
	<hr/> 38	<hr/> 100
	<hr/> <hr/>	<hr/> <hr/>

Table 3

When your clients have asked you to consider an override of specific accounting rules in order to achieve 'imagen fiel' have you:

	Number	%
Agreed in all cases	6	30
Disagreed in all cases	10	50
Agreed in some	4	20
Disagreed with others		
	<u>20</u>	<u>100</u>

Table 4

Has any client wished to invoke the 'imagen fiel' / 'true and fair' override?

	Spain	UK
YES	53%	75%
NO	47%	25%

When asked whether the auditor had ever advised the client to invoke the 'imagen fiel' override 70%, as shown in table 5, replied no. Where such advice was given it was generally accepted, as shown in table 6. Auditors' willingness to give such advice in Spain appears similar to the position in the UK as reported by Parker and Nobes 1991 as shown in table 7.

Table 5

How many times have you advised a client to override a specific accounting rule in order to give 'imagen fiel'?

	Number	%
Never	27	70
1	4	11
2	1	3
3	1	3
4	0	0
5	0	0
more than 5	3	8
no reply	2	5
	<hr/>	<hr/>
	38	100
	<hr/> <hr/>	<hr/> <hr/>

Tabla 6

In cases where you have advised a client to override a specific accounting rule in order to give 'imagen fiel', has your advice been accepted?

	Number
Always	8
Sometimes yes	1
Sometimes no	0
Never	0
	<hr/>
	9
	<hr/> <hr/>

Table 7

Has the auditor ever advised a client to invoke the 'imagen fiel'/'true and fair' override?

	Spain	UK
YES	30%	40%
NO	70%	60%

Turning to the additional disclosure requirement, 81% of auditors had at some time persuaded clients to provide additional information in order to give 'imagen fiel' (see table 8). By contrast only 45% had experienced clients instigating the provision of additional information to provide 'imagen fiel', while 50% had experienced client resistance to the provision of additional information.

Table 8

Provision of extra information to give 'imagen fiel'

	YES	NO	NO REPLY
Have you ever had a client decide to give extra information in order to present 'imagen fiel'?	45% (17)	50% (19)	5% (2)
Have you ever advised a client to give extra information in order to present 'imagen fiel' and had your advice accepted?	81% (31)	16% (6)	3% (1)
Have you ever advised a client to give extra information in order to present 'imagen fiel' and not had your advice accepted?	50% (19)	45% (17)	5% (2)

Table 9 summarises auditors' views on a number of aspects of 'imagen fiel'. Overall responses were positive, with over 75% agreeing with the views that 'imagen fiel' is both a useful and a clear guiding principle for auditors, and that it will promote better accounting in Spain.

However, 49% saw 'imagen fiel' as posing problems of interpretation for auditors and respondents were evenly divided as to whether or not 'imagen fiel' is alien to the Spanish accounting traditions. Some problems of interpretation for the business community were seen, with 50% disagreeing with the proposition that 'imagen fiel' offers a clear guiding principle for business, 67% seeing problems of interpretation for business, and 64% seeing problems of interpretation for users of accounts.

Table 9 Auditors' views on 'imagen fiel'

	Strongly Agree	Agree	Neither Agree or Disagree	Disagree	Strongly Disagree
'Imagen fiel' is a useful guiding principle for auditors	42% (15)	36% (13)	14% (5)	3% (1)	5% (2)
'Imagen fiel' is a clear guiding principle for auditors	35% (13)	22% (8)	22% (8)	13% (5)	8% (3)
'Imagen fiel' is a clear guiding principle for business	17% (6)	11% (4)	22% (8)	44% (16)	6% (2)
'Imagen fiel' is alien to Spanish accounting tradition	3% (1)	28% (10)	39% (14)	11% (4)	19% (7)
'Imagen fiel' will promote better accounting in Spain	32% (12)	45% (17)	18% (7)	5% (2)	0
'Imagen fiel' raises problems of interpretation for auditors	3% (1)	46% (17)	14% (5)	30% (11)	7% (3)
'Imagen fiel' raises problems of interpretation for business	6% (2)	61% (22)	17% (6)	11% (4)	5% (2)
'Imagen fiel' raises problems of interpretation for users of accounts	3% (1)	61% (22)	17% (6)	8% (3)	11% (4)

When asked whether some form of overall defining objective for accounting, such as 'imagen fiel', was desirable, 89% replied yes (see table 10). However, when asked whether 'imagen fiel' was the best term to use one third of those replying said no.

Table 10

Do you believe that we need a defining objective for accounting?

	Number	%
YES	34	89
NO	3	8
NO REPLY	1	3
	<u>38</u>	<u>100</u>

Do you believe that 'imagen fiel' is the best term to use?

	Number	%
YES	20	53
NO	11	29
NO REPLY	7	18
	<u>38</u>	<u>100</u>

Finally, respondents were presented with three cases where clients might seek to invoke the 'imagen fiel' override. The cases are presented in full in appendix A. To summarise the three cases briefly:

- a) Case 1 involves setting off the unamortised discount on a debenture against the nominal value of the debenture, contrary to the PGC which shows that the two amounts separately. Ernst and Young (1995) report an example of a company using the 'imagen fiel' override in this way.
- b) Case 2 involves a company in translating an investment in an associated company in Mexico at the historic rate, rather than following the PGC and using the closing rate. The reason is that a major devaluation in Mexico, that would give rise to a major loss on retranslation of the investment, has actually enhanced the international

competitiveness of the associate and so increased its value. Again Ernst and Young (1995) report an example of a company using the 'imagen fiel' override in this way.

- c) Case 3 involves a company in an in-substance defeasance of debt scheme. The company proposes to remove the loan and related investments from the Balance Sheet, contrary to the 'no set off' rules of the EU 4th Directive which have been enacted in the Spanish PGC. Walton (1985) speculates that the 'true and fair' override might be used in this way.

We would see these three cases as offering an ascending order of risk in applying the override:

- a) Case 1 is purely a matter of presentation, with precedent to support its use.
- b) Case 2 raises issues both of presentation and measurement, and also has precedent to support it.
- c) Case 3 raises issues both of presentation and measurement. We are not aware of any Spanish precedent to support it.

Table 11 summarises responses. In all cases respondents show a substantial majority against use of the override, even in case 1 where no measurement issue is involved and there is a precedent in Spain for the proposed approach.

Table 11

Would the auditor agree to use of the 'imagen fiel' override in each case?

	YES	NO
CASE 1	26% (10)	74% (28)
CASE 2	11% (4)	89% (34)
CASE 3	5% (2)	95% (36)
TOTAL	14% (16)	86% (98)

Conclusion

The results of our survey must necessarily be treated with some caution as they are based upon a relatively small sample of auditors. However, within the Spanish context, the response rate is very high, indicating a keen interest on the part of practitioners in the question of the adoption of 'imagen fiel' into the Spanish accounting environment.

Our survey indicates that the 'imagen fiel' concept is treated seriously by our respondents, and there is a clear measure of agreement by a majority that the concept is both useful and clear guiding principle for auditors. However, a substantial proportion of respondents also affirm that the concept presents problems of interpretation for auditors, for business and for users of the accounts.

The position of Spanish auditors, then appears in some respects to be strikingly similar to the attitudes of auditors in the UK which are described earlier in our paper; namely, that the term is useful but does not lend itself to easy interpretation.

Mixed views emerge on the usefulness of the 'override' provision. While it is clear from the results of the case study questions that auditors would generally be reluctant to consider use of the 'override', nevertheless Spanish auditors are prepared to agree to its use in unusual situations. Hypothetical questions apart, our survey provides evidence that auditors have agreed to the use of the override in practice.

In summary, then, we present the following assertions:

- 1) 'True and fair' has translated well into the Spanish accounting environment in the sense that it is considered to be both useful and mysterious, a somewhat contradictory position which reflects the experience of using 'true and fair' in the UK.
- 2) Spanish auditors take the concept of 'imagen fiel' seriously, and although they are reluctant to accede to request to use the 'override' provision, there is clear evidence that the 'override' is being adopted in a minority of cases in practice.

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Appendix

Scenario A

Your client has issued zero coupon bonds. Following the PGC the Balance Sheet will show the gross amount at which the bonds are redeemable as a liability and that part of the discount not yet written off as a fictitious asset. Your client feels that this accounting treatment fails to give '*imagen fiel*' because the liability shown is greater than if an alternative financing arrangement had been used, and accordingly proposes to show the liability net of the related unamortised discount.

Scenario B

Your client has an investment in an associated company in Mexico. During the past year the national currency, the Peso, has been subject to major devaluation.

Following the PGC the investment should be restated at the closing exchange rate and the loss of value accounted for. Your client believes that this would fail to show '*imagen fiel*', because the economic impact of the devaluation has actually been to enhance the value of the investment. Accordingly they propose that no change in the amount at which the investment is shown in the accounts should be made.

Scenario C

In 1990 your client received a loan of 10 million pesetas repayable after 20 years from a financial institution. Recently your client acquired government bonds paying interest and maturing in such a way as to cover exactly the obligations to pay interest and repay capital under the loan agreement. Your client placed the government stock in an irrevocable trust to meet the loan obligation. Despite the principle of 'no set off' in the PGC, your client takes the view that to give '*imagen fiel*' the loan and the related government bonds should be cancelled out against each other and not shown in the Balance Sheet.

