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TFV and GoB
Anglo-German Lessons for International Accounting
Harmonisation

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Anglo-German lessons for International Accounting Harmonisation

Abstract

The core of this paper is an analysis and comparison of the UK-originated True and Fair View principle and the German-originated Grundsätze Ordnungsmässiger Buchführung principle. It is our contention that TFV and GoB, in their different ways and different environments, are designed to achieve, and traditionally have successfully achieved, the same outcome. This is to provide flexibility so that the financial statements are able to achieve their generally desired purposes without being excessively constrained by detailed rules and regulations.

This analysis and comparison, which we believe to be of considerable interest in its own right, is not presented here as an end in itself. The paper presents arguments for the necessity of flexibility in financial reporting, and therefore in financial reporting regulation.

These general arguments serve two purposes. Firstly, they provide a rationale and explanation for our specific propositions regarding TFV and GoB. Secondly, they provide a general rationale for our proposition that global accounting regulations, however rigorous the international process for the agreement of the wording of international standards, may well be interpreted and applied in different (unharmonised) ways, at least for the foreseeable future. But as a third point, the detailed analysis of GoB and TFV provides a case study illustration of our general contention. In summary, financial reporting is always concerned with purpose. Harmonised reporting is logically impossible without harmonized purpose. The process for achieving the purpose may be different in detail to reflect the 'local' context, as GoB and TFV so vividly illustrate, but purpose will always affect actions, and interpretations of regulation.

Keywords: True and View; *Grundsätze Ordnungsmässiger Buchführung*; IASB; harmonisation; globalisation; economic reality.

1. INTRODUCTION

The core of this paper is an analysis and comparison of the UK-originated True and Fair View principle and the German-originated Grundsätze Ordnungsmässiger Buchführung principle. The Anglo-German author team explore their respective traditions and then develop a comparison. It is generally argued and accepted in the literature, at least in the European context, that the UK and Germany are ‘opposites’ in their accounting traditions. In several important senses, such as the different legal infrastructures, and the different finance-raising infrastructures, this is true. But it is our contention that TFV and GoB, in their different ways and different environments, are designed to achieve, and traditionally have successfully achieved, the same outcome. This is to provide flexibility so that the financial statements are able to achieve their generally desired purposes without being excessively constrained by detailed rules and regulations.

This analysis and comparison, which we believe to be of considerable interest in its own right, is not presented here as an end in itself. The paper presents arguments for the necessity of flexibility in financial reporting, and therefore in financial reporting regulation. Some of these arguments are fundamental, and grounded in a philosophically-based analysis of concepts of (economic) reality. Some are more directly related to the IASB and to the topical “principle v rules” debate amongst the key global regulators.

These general arguments serve two purposes. Firstly, they provide a rationale and explanation for our specific propositions regarding TFV and GoB. Secondly, they provide a general rationale for our proposition that global accounting regulations, however rigorous the international process for the agreement of the wording of international standards, may well be interpreted and applied in different (unharmonised) ways, at least for the foreseeable future. But as a third point, the detailed analysis of GoB and TFV provides a case study illustration of our general contention. In summary, financial reporting is always concerned with purpose. Harmonised reporting is logically impossible without harmonized purpose. The process for achieving the purpose may be

different in detail to reflect the ‘local’ context, as GoB and TFV so vividly illustrate, but purpose will always affect actions, and interpretations of regulation.

The rest of this paper is structured as follows. Sections 2 and 3 develop, respectively, the traditional German GoB philosophy and the traditional British TFV philosophy. Section 4 provides a theoretical underpinning to our contention that economic (and therefore financial) reality is inherently subjective, and even an approximate agreement on perception of that reality is dependent on contextual and cultural similarities and agreements. Section 5 analyses aspects of the IASB’s approach to standard-setting, especially regarding the issue of flexibility. Sections 6 and 7 consider, respectively, the effects of the introduction of IFRSs in Germany and the UK. Finally section 8 presents a summation and conclusions.

2. TRADITIONAL GERMAN POSITION: A HISTORICAL PERSPECTIVE OF GoB

The ‘Grundsätze ordnungsmäßiger Buchführung’ (GoB – ‘principles of orderly accounting’¹) are an indeterminate concept of law (Leffson, 1987a: 21-22; Kruse, 1978: 104). Although the German Commercial Code (HGB) determines that ‘Jeder Kaufmann ist verpflichtet, Bücher zu führen und in diesen seine Handelsgeschäfte und die Lage seines Vermögens nach den Grundsätzen ordnungsmäßiger Buchführung ersichtlich zu machen’ (Art. 238 HGB), and the annual accounts have to be prepared in accordance with the GoB (Art. 243 HGB), the legislature has never defined nor delineated the term in the law. Therefore, over the years different opinions arose on the content of GoB, their legal status and how to derive them. The answers to the questions on the ‘nature’ and

¹ There exist different translations in the literature for the term ‘Grundsätze ordnungsmäßiger Buchführung’ (GoB) as for example ‘principles of orderly bookkeeping’ (Macharzina and Langer, 2004: 258), ‘principles of regular bookkeeping’ (Ordelheide and Pfaff, 1994: 93), ‘principles of proper accounting’ (Haller, 2003: 93), ‘principles of proper bookkeeping’ (Ballwieser, 2001a: 1223), ‘German accepted accounting principles’ (Fey and Fladt, 2006: E 183). These translations carry different connotations, and implied meanings. Here we refer to GoB or ‘principles of orderly accounting’ throughout.

‘sources’ of GoB have varied strongly over time and have been heavily influenced by the prevailing spirit of the times.

HGB 1897

The notion ‘Grundsätze ordnungsmäßiger Buchführung’ was for the very first time explicitly mentioned in the HGB 1897. It stated ‘Jeder Kaufmann ist verpflichtet, Bücher zu führen und in diesen seine Handelsgeschäfte und die Lage seines Vermögens nach den Grundsätzen ordnungsmäßiger Buchführung ersichtlich zu machen’ (Art. 38 HGB 1897). I.e. every businessman² was required to keep accounts in which he had to show his transactions and his states of affairs in accordance with ‘the principles of orderly accounting’. The legislator justified the introduction of this indefinite legal notion with the argument that dependent on the object, nature and volume of a business the accounting requirements could be different (Reichstag, 1897: 985; Moxter, 1980: 257). Since the *Denkschrift zum Entwurf eines Handelsgesetzbuches* determined that ‘nach den Gepflogenheiten sorgfältiger Kaufleute ist zu beurtheilen, wie die Bücher geführt werden müssen’ (Reichstag, 1897) at that time the dominant opinion developed that GoB should be derived inductively from the practice of careful and orderly businessmen (Kruse, 1978: 52; Lehmann, 1930: Art. 38, remark 15; Schön: 1997: 144). Influenced by a laissez-faire philosophy that was predominant at that time, the legislator believed that businessmen would in their own interest develop appropriate accounting principles useful for monitoring and conducting their business (Leffson, 1987a: 131 – 133; Le Coutre, 1957: 2016). He therefore never specified how a careful and orderly businessman could be determined.

Aktienrechtsnotverordnung 1931, Aktiengesetz 1937, 1959 and 1965

This view changed following financial statement manipulation and the failure of large business entities caused by the beginnings of the economic depression. The opinion developed that improper accounting practices could not constitute GoB (Havermann,

1961: 986; Schmalenbach, 1933: 232; Schulze zur Wiesch, 1961: 38-39). At best GoB could only be what was regarded as appropriate accounting practice of orderly and honourable businessmen (Mutze, 1969: 62; Schmalenbach, 1933: 232). Since, however, the orderly and honourable businessmen could not be determined, a new understanding of GoB became necessary. With legislation passed in 1931, 1937, 1959 and 1965 for stock corporations (Aktiengesellschaften – AGs) the legislature made clear that accounting principles developed in practice could not always be expected to constitute GoB (Leffson, 1987a: 135). By specifying recognition and measurement rules imposed on AGs in more detail and introducing detailed formats for the balance sheet and the profit and loss account for this legal type of entity, several ‘inappropriate’ accounting methods and principles established in business practice were overridden by legislation (Leffson, 1987a: 135). Thus with the reform of the accounting law applicable for stock corporations the legislature stopped relying primarily on the accounting principles developed in practice and started to interpret and specify orderly accounting methods for AGs through legislation instead (Leffson, 1987a: 135; Niemann, 2000:11).

Since in Germany taxation is closely linked to financial accounting³ it was often the tax courts that were in practice confronted with the specification and interpretation of the GoB (Moxter 1980: 255; Mutze, 1969: 56). While doing this, judges increasingly fell back on the accounting principles and methods codified in the accounting law for stock corporations and for other legal types of business entities (Moxter, 1980: 267; *ibid.*, 1983: 15–16). Inter alia fostered by these judicial decisions of tax courts many of the major accounting principles codified in the AktG 1965 for stock corporations finally developed in practice into ‘principles of orderly accounting’ and thus attained relevance for all business entities (Beisse, 1994: 8; Leffson, 1987a: 135; Niemann, 2000:11). Thus,

² ‘Businessmen’ is a translation of ‘Kaufleute’. This word appears in German law, and therefore has a technical meaning not indicated by the translation.

³ According to the *Maßgeblichkeitsprinzip* that evolved at the end of the nineteenth century and which was implemented in the tax code of the German Reich in 1920, the accounting principles applied for commercial accounting are generally binding for taxation. Since 1969 the *Einkommensteuergesetz* refers directly to GoB requiring that the financial assets and liabilities subject to taxation needs to be determined according to the principles of orderly accounting.

with the stock corporation legislation passed in 1931, 1937, 1959, 1965, the accounting practice of careful and orderly businessmen was no longer regarded as the single source of GoB. In 1967 the *Bundesfinanzhof* (BFH – German Supreme Tax Court) made the deductive development of GoB from the underlying accounting purposes clear: ‘Handelsrechtliche Grundsätze ordnungsmäßiger Bilanzierung sind die Regeln, nach denen der Kaufmann zu verfahren hat, um zu einer dem gesetzlichen Zweck entsprechenden Bilanz zu gelangen, nicht aber die Regeln, die tatsächlich eingehalten werden. Für ihre Ermittlung kann freilich die tatsächliche Übung der Kaufleute eine wichtige Erkenntnisquelle sein ..., aber sie hat nicht die Kraft, Grundsätze ordnungsmäßiger Bilanzierung rechtsschöpferisch zu gestalten’⁴ (BFH, 1967) [GoB are those principles that need to be applied by a businessman to come to a balance sheet that fulfills legal purposes, and not those rules that are just applied in practice. To determine GoB the actual practice of businessmen can of course be an important source ..., but it does not have the power to legally establish GoB] Thus, increasingly the opinion developed that GoB are legal rules that should be derived (teleologically) deductively from underlying purposes (Döllerer, 1959: 1220; Leffson, 1964: 38-39; Adler et al, 1968: 21-22; Christoffers, 1969: 27-28) respectively from superior principles (Obersätze) (Goedeler and Müller, 1979: 176; Schneider, 1983: 144) since accounting purposes were often regarded as too vague for being an appropriate basis for a (telological) GoB deduction (Goedeler and Müller, 1979: 176). Useful information in this process could be provided by codified law, judicial decisions, the academe, the relevant accounting literature and the accounting practice (Adler et al, 1968: 22). Nevertheless, the deductive development of GoB raised the question of the underlying accounting purposes/superior principles. These had not been explicitly stated in the accounting law and, therefore, a

⁴ Since discussions existed on whether GoB relate only to bookkeeping or also to the annual accounts (Schmalenbach, 1933: 225-229) the legislature used in the Aktienrechts(not)verordnung 1931 (Art. 260b) the notion ‘Grundsätze ordnungsmäßiger Buchführung und Bilanzierung’. Therefore, the dominant opinion arose that in a narrower sense the ‘Grundsätze ordnungsmäßiger Buchführung’ only relate to bookkeeping whereas ‘Grundsätze ordnungsmäßiger Bilanzierung’ relate to the annual accounts. The Stock Corporation Act 1937 (Art. 129, Aktiengesetz 1937) and the Stock Corporation Act 1965 (Art. 149 Aktiengesetz 1965) however did not continue with this distinction. Based on the assumption that the ‘Grundsätze ordnungsmäßiger Buchführung’ also included the ‘Grundsätze

uniform opinion regarding their content did not exist (Baetge, 1976; Goerdeler and Müller, 1979: 176; Maul, 1974: 729-730; Schneider, 1983: 143 – 144; Waldner, 1961: 1110).

Additionally, inspired by the true and fair view principle codified in the British Companies Act the *Aktienrechts(not)verordnung 1931* (*Verordnung des Reichspräsidenten über Aktienrecht, Bankenaufsicht und über eine Steueramnestie vom 19. September 1931* – Stock Corporations (Emergency) Decree 1931) also introduced for the very first time for stock corporations explicitly the requirement to make the annual accounts clear and transparent so that they give participants a secure as possible insight in the affairs of the company ('Der Jahresabschluß ist so klar und übersichtlich aufzustellen, daß er den Beteiligten *einen möglichst sicheren Einblick* in die Lage der Gesellschaft gewährt') (Art. 260b). In the preceding draft to the *Aktienrechts(not)verordnung* the legislature made clear that its intention was to stress the 'principle of clarity' (*Bilanzklarheit*) though it did not regard the legal content of this newly drafted principle as material. The primary objective for the introduction of the 'principle of clarity' was to stress the purpose underlying the accounting rules, namely the newly introduced rules on the formats for the balance sheet and the profit and loss account (Draft Aktiengesetz, 1930: 113). This general clause therefore, was not regarded to prevent secret reserves (Ullmann, 1930: 2634). It was primarily directed towards the formats of accounts and supposed to provide guidance in court decisions for cases not covered in the law (Draft Aktiengesetz, 1930: 113; Schlegelberger et al, 1937: 567).

With the enactment of the *Aktiengesetz 1965* (AktG 1965 – Stock Corporation Act 1965), the legislature modified the content of the 1931 newly introduced general clause which also continued into the *Aktiengesetz 1937* (AktG 1937 – Stock Corporation Act 1937). A secure as possible insight into the assets, liabilities and results of the company had now to be given only in compliance with existing measurement principles ('Der Jahresabschluß

ordnungsmäßiger Bilanzierung' (Adler et al, 1968: 21) they referred to 'Grundsätze ordnungsmäßiger Buchführung' only.

hat den Grundsätzen ordnungsmäßiger Buchführung zu entsprechen. Er ist klar und übersichtlich aufzustellen und muß *im Rahmen der Bewertungsvorschriften* einen möglichst sicheren Einblick in die Vermögens- und Ertragslage der Gesellschaft geben') (Art. 149, AktG 1965). The general clause of the AktG 1937 was regarded as being misleading since several of the codified measurement principles (as for example the prohibition to value assets above historical cost) still allowed to build secret reserves and therefore, were regarded as conflicting with the requirement to give a secure as possible insight into the affairs and profit or loss of the company (Rechtsausschuss, 1965, Bericht des Abgeordneten Dr. Wilhelmi: p. 27, Art. 142). The first draft to the AktG 1965 therefore totally excluded such a general clause (Draft Aktiengesetz, 1960: 166). The law committee later charged with the review of the draft did however take a different view. It regarded the inclusion of such a general clause, expressing the general requirement (in formal and material respects) on annual accounts, as useful, especially as a guiding principle for choosing among various accounting options that continued under the new Act (Rechtsausschuss, 1965, Bericht des Abgeordneten Dr. Wilhelmi: p. 27, Art. 142). The law committee therefore suggested to restrict the general clause of the AktG 1937 in such a manner that a secure as possible insight has only be given in compliance with existing measurement principles. The proposal of the law committee finally prevailed and the general clause, though restricted through applicable measurement principles, continued in the AktG 1965. But unlike the AktG 1937 the general clause of the AktG 1965 was no longer primarily a declamatory phrase mainly restricted to formal aspects of accounts but was regarded to determine the formal and material accounting requirements and guide decisions on available accounting options (Kropff, 1973: 57).

Fourth Directive

The next major reform of the accounting law was provoked by the implementation of the 4th, 7th and 8th European Community Directives. The three EU directives were implemented simultaneously through the so-called *Bilanzrichtliniengesetz* (BiRiLiG – European Union Accounting Directives Act) in 1985. Although the *Aktiengesetz 1965* strongly influenced the development of the 4th Directive, its implementation nevertheless

forced many changes, and the German legislature used this as the basis for a comprehensive reform and restructuring of the accounting law for all business enterprises (Haller, 2003: 94), even though this was not required by the Directives as they only addressed limited liability entities. The BiRiLiG moved almost all relevant accounting rules for all types of entities to a dedicated part (the third book) of the HGB (Haller, 2003: 94). Thus, the HGB was restructured in the way we find it today: with a basic section consisting of general accounting rules applicable to all enterprises irrespective of their legal type, and subsequent sections with additional requirements for companies limited by shares, cooperatives etc.

With the BiRiLiG several of the AktG's measurement and recognition principles that continued due to Germany's influence during its drafting in the 4th Directive were, in the process of the transformation of the directive, moved to the HGB's basic section, i.e. imposed on all enterprises irrespective of their legal form (albeit with some relaxations and more flexibility to create hidden reserves). The rationale for doing this was, that many of the major principles of the AktG 1965 had already been regarded as GoB and therefore had in practice been applied by all business enterprises (see above). Thus, the implementation of the AktG's accounting principles in the basic section of the HGB through the BiRiLiG was primarily a codification of already existing, previously non-codified GoB and, therefore, did in practice not cause a radical change. It improved however, legal certainty, hindered (as happened with the AktG 1965) the process that accounting requirements specifically codified for companies limited by shares could via GoB interpretation and specification by judges generally be imposed on other enterprises (Draft Bilanzrichtliniengesetz, 1982: 70; Draft Bilanzrichtliniengesetz, 1983: 71; Rechtsausschuss, 1985: 88) and prevented the development of divergent GoB between different legal types of entities (Draft Bilanzrichtliniengesetz, 1983: 65). The latter was especially important since the legislature intended to retain the formal close connection between financial reporting and tax computation, the *Maßgeblichkeitsprinzip*, and therefore aimed at creating a uniform tax basis for all business enterprises. Divergent GoB, in contrast, could have threatened fiscal neutrality (Draft Bilanzrichtliniengesetz, 1982: 65; Draft Bilanzrichtliniengesetz, 1983: 65).

Furthermore, the implementation of the 4th Directive also confronted the German legislature with the codification of the British - inspired *true and fair view principle* as outlined in Article 2 of the 4th Directive (Fourth Council Directive 78/660/EEC of 25 July 1978). Since the *Aktiengesetz 1965* strongly influenced the development of the 4th Directive the first draft of Article 2 of the 4th Directive was almost identical to the wording of the *Aktiengesetz 1965* (Alexander, 1993: 61; Biener, 1979: 25-27), referring to GoB ('Der Jahresabschluss hat den Grundsätzen ordnungsmäßiger Buchführung zu entsprechen' – 'The annual accounts shall conform to the principles of regular and proper accounting') and requiring 'Der Jahresabschluss ist klar und übersichtlich aufzustellen. Er hat im Rahmen der Bewertungs- und Gliederungsvorschriften einen möglichst sicheren Einblick in die Vermögens-, Finanz- und Ertragslage der Gesellschaft zu geben' (or as in the English version of the 4th Directive: the annual accounts 'shall be drawn up clearly and, in the context of the provisions regarding the valuation of assets and liabilities and the layout of accounts, shall reflect as accurately as possible the company's assets, liabilities, financial position and results') (Article 2, 1971 Draft of the Fourth Directive). [For English-language texts of all the various drafts of the relevant section, and a brief discussion, see e.g. Alexander and Nobes (2004: 101/2).] This was however modified in later versions after the UK joined the EC (Walton, 1997: 723). In the final version of the 4th Directive the 'true and fair view principle' was established as an 'overriding principle' as suggested by the Economic and Social Committee in charge and the European Parliament. The reference to GoB was completely dropped with the argument that the requirement to give a true and fair view automatically implies compliance with GoB (Biener, 1979: 25-29).⁵

The German legislature did not exactly implement the true and fair view principle as required by Article 2 (3) – (5) of the 4th Directive. Firstly, based on the wording in the *Aktiengesetz 1965* and as proved effective (Draft Bilanzrichtliniengesetz, 1982: 76), the

reference to GoB was maintained. Thus, according to Art. 264 , para. 2 HGB a true and fair view of the company's assets, liabilities, financial position and profit or loss has only to be given in accordance with GoB⁶ ('Der Jahresabschluß der Kapitalgesellschaft hat unter Beachtung der Grundsätze ordnungsmäßiger Buchführung ein den tatsächlichen Verhältnissen entsprechendes Bild der Vermögens-, Finanz- und Ertragslage der Kapitalgesellschaft zu vermitteln').⁷ Secondly, in specific cases where a true and fair view can not be presented, additional information must be given in the notes. Thus, in addition to Article 2 (4) of the 4th Directive which requires that when a true and fair view can not be presented additional information must be given, the German legislature specifies that this information has to be given in the notes. Thirdly, the German legislature did not explicitly implement Article 2 (5) of the 4th Directive which requires to depart from specific provisions of the Directive if their application is incompatible with the obligation to present a true and fair view. Thus the true and fair view principle was not explicitly codified as an overriding principle. The departure from Article 2 (5) of the 4th Directive was justified with the argument that under German legal understanding legal rules have always been applied in such a manner that the purpose and meaning attached to legal requirements by the legislature are fulfilled ('Auf die ausdrückliche Übernahme von Artikel 2 Abs. 5 der Vierten Richtlinie wurde verzichtet, weil nach allgemeinen Grundsätzen des deutschen Rechts die Anwendung gesetzlicher Vorschriften jeweils so zu erfolgen hat, daß der den gesetzlichen Vorschriften vom Gesetzgeber

⁵ The EC and the Member States have recorded in a protocol note that compliance with the provisions of the Fourth Directive are usually sufficient to give a true and fair view (Biener and Berneke, 1986: 132).

⁶ An equal requirement was introduced for group accounts in Article 297, para. 2 HGB.

⁷ For translation-based differences between the English and the German version of the Fourth Directive see Alexander (1993: 62-63). It is also interesting to notice, that the true and fair view requirement (in contrast to the first draft of the *Bilanzrichtliniengesetz*) was only enacted for companies limited by shares. It had not been included in the basic section of the Third Book of the HGB which includes general accounting rules applicable to all enterprises irrespective of their legal type. Restricting the application of the true and fair view requirement to companies limited by shares was proposed by the Law Committee in charge, to avoid the impression that the rules applicable to enterprises that are not within the scope of the Fourth Directive will be tightened through the *Bilanzrichtliniengesetz* (Rechtsausschuss, 1985: 91).

beigelegte Sinn und Zweck erfüllt wird') (Draft Bilanzrichtliniengesetz, 1982: 77).⁸ According to this functional or teleological interpretation of law, the meaning and purpose of a law attached by the legislature⁹ are more relevant than its wording (Ordelheide, 1993: 86; similar Beine, 1995: 470; Claussen, 1987: 88-89; Schulze-Osterloh, 1986: 541-542) and therefore permits departure from the wording of a specific rule in order to apply another one if it better fits the objectives of the law (Ordelheide, 1996: 495)¹⁰. However, within this context, the restriction of the overall objective of the annual accounts to give a true and fair view *within the GoB* as codified in Art. 264, para. 2 HGB gains importance (Ordelheide, 1996: 496). Since the phrase true and fair view is undetermined, the reference to GoB clarifies the meaning of a true and fair view (Budde and Förschle, 1988: 37-38; Großfeld, 1986: 199, Institut der Wirtschaftsprüfer in Deutschland e.V., 1979: 170), which is necessary for a teleological interpretation of the law. Thus, GoB restrict the true and fair view requirement (Budde and Förschle, 1988: 37; Großfeld, 1986: 193; Leffson, 1987b: 324; Richter, 1988: 2216) especially as the balance sheet and profit and loss account is regarded.

Correspondingly, the reference to GoB was assumed to prevent accounting treatments complying with GoB, but not necessarily providing the best insight into the financial assets, liabilities, financial position or results, from being overridden by the true and fair view requirement via a teleological interpretation of the law (Ordelheide, 1993: 85; Ordheide, 1996: 496). The legislature of the *Bilanzrichtliniengesetz* concluded, therefore, that the general norm to provide a true and fair view as enacted in the German HGB is only relevant if doubts exist on the application or interpretation of a specific

⁸ There have been many discussions in the literature whether Germany has correctly implemented Article 2 (5) of the 4th Directive. (e.g. Ordheide 1993; Ordheide 1996; Alexander, 1993; Streim, 1994: 396-397).

⁹ Though a teleological interpretation considers the objectives and purposes attached by the historical legislature it is not confined to a history based interpretation (Larenz, 1975: 321).

¹⁰ Such a teleological interpretation of the law is an exemption to the general Roman Law principle that *lex specialis* (i.e. a more specific legal rule) generally takes precedence over *lex generalis* (i.e. a more general rule) (Ordheide, D. (1993. 86).

rule,¹¹ or in cases where specific rules are not available in the law (Draft Bilanzrichtliniengesetz, 1983: 76).¹² The general norm does however not allow to determine the content or scope of annual accounts by deviating from legal rules (Draft Bilanzrichtliniengesetz, 1983: 76; Streim, 1994: 396), and it therefore does not permit to apply an accounting method that provides a true and fair view but contradicts GoB (Ordelheide, 1993: 85). Therefore, according to Moxter's Abkoppelungsthese ('separation thesis'), the true and fair view requirement relates primarily to the format of the balance sheet and the profit and loss account and the disclosures in the notes (Moxter, 1995: 427). The annual accounts consisting of the balance sheet, the profit and loss account and the notes to the accounts are considered as a composite whole and must altogether provide a true and fair view. Therefore, restrictions on the true and fair view resulting from GoB or other legal provisions can be compensated by additional disclosures in the notes (Adler et al, 1997: notes 99-104 to § 264; Moxter, 1986: 67). However, the reasoning to the Draft *Bilanzrichtliniengesetz* makes clear that additional disclosures, not explicitly required by the law, need only be given in the notes if in exceptional cases the application of the legal rules does not lead to a true and fair view (Draft Bilanzrichtliniengesetz, 1983: 76).

In summary, the restriction of the true and fair view principle via GoB was primarily intended to prevent companies from additional accounting burdens and accounting methods other than those included in the law which could otherwise have resulted from a teleological interpretation of the true and fair view requirement (Ordelheide, 1996: 496) and which could have in the end due to the *Maßgeblichkeitsprinzip* also influenced

¹¹ This complies with the principle that in case *lex specialis* requires interpretation, *lex generalis* applies (Leffson, 1979: 214).

¹² Discussions exist whether the true and fair view principle is relevant for exercising accounting choices that may all comply with GoB but not with the requirement to provide a true and fair view. Whereas Ordelheide (1993: 85) and Budde and Förtschle (1988: 39-42) agree that the true and fair view principle can restrict accounting options available under the HGB respectively GoB, Adler et al (1997: § 264 note 107) and Schildbach (1987: 7-9) in contrast, disagree arguing that the legislature explicitly provided accounting options that contradict the true and fair view requirement, as for example the option for tax based depreciations. Adler et al (1997: § 264 note 107) therefore conclude that the notes to the accounts inform the users on the accounting methods applied respectively any changes in accounting methods and the reasons for that and therefore an information deficit does not exist.

taxation (Beisse, 1990a: 2012). In addition, the restriction also intended to increase legal certainty, since an absolute true and fair view without reference to specific conventions cannot be provided (Budde and Förtschle, 1988: 37-38; Institut der Wirtschaftsprüfer in Deutschland e.V., 1979: 170; Jonas, 1980: 33; Lang, 1986: 225).

Post Fourth Directive

References to GoB can be found in the HGB¹³ as well as in the income tax code¹⁴. Though the current version of the HGB refers in several articles directly to GoB, the term GoB has till today not been defined in the law and is therefore still an indefinite legal concept. Despite various efforts of academics to systemize GoB (Baege and Kirsch 2002; Moxter 2002; Leffson 1987a), an unanimous agreement has not been reached yet, neither on their content and their structure nor their determination.

¹³ Namely; in the HGB's basic section applicable to all businessman:

- Art. 235, para. 1 HGB:
'Jeder Kaufmann ist verpflichtet, Bücher zu führen und in diesen seine Handelsgeschäfte und die Lage seines Vermögens nach den Grundsätzen ordnungsmäßiger Buchführung ersichtlich zu machen' [every businessman is required to keep books and in which he records his business transactions and the enterprises's assets and liabilities according to GoB].
- Art. 243, para. 1 HGB:
'Der Jahresabschluß ist nach den Grundsätzen ordnungsmäßiger Buchführung aufzustellen' [the annual accounts have to be prepared in accordance with GoB].

And in the HGB's special section applicable to companies limited by shares and commercial partnerships:

- Art. 264, para. 2 HGB:
'Der Jahresabschluß der Kapitalgesellschaft hat unter Beachtung der Grundsätze ordnungsmäßiger Buchführung ein den tatsächlichen Verhältnissen entsprechendes Bild der Vermögens-, Finanz- und Ertragslage der Kapitalgesellschaft zu vermitteln' [a true and fair view of the company's assets, liabilities, financial position and profit or loss has to be given in accordance with GoB].
- Art. 297, para. 2 HGB (applicable to group accounts):
'Der Konzernabschluß ist klar und übersichtlich aufzustellen. Er hat unter Beachtung der Grundsätze ordnungsmäßiger Buchführung ein den tatsächlichen Verhältnissen entsprechendes Bild der Vermögens-, Finanz-, und Ertragslage des Konzerns zu vermitteln' [consolidated financial statements must be clear and transparent. In accordance with GoB, they have to give a true and fair view of the group's assets, liabilities, financial position and profit or loss].

¹⁴ Currently the *Einkommensteuergesetz* (income tax code) requires: 'Bei Gewerbetreibenden ... ist für den Schluss des Wirtschaftsjahres das Betriebsvermögen anzusetzen ..., das nach den handelsrechtlichen Grundsätzen ordnungsmäßiger Buchführung auszuweisen ist' (Art. 5, para. 1 Einkommensteuergesetz as amended September 2005). Thus for determining taxable income the principles of orderly accounting have to be considered. However, GoB are only binding to the extent they are not in conflict with special tax rules.

Purposes of GoB

With the enactment of the *Bilanzrichtliniengesetz* in 1985 the legislature codified several elements of GoB in the HGB (see above), but not all. This renunciation of defining and codifying all GoB in the HGB is not a loophole in the law, it rather intends to ensure a flexible development of GoB (Baetge and Kirsch, 2002: note 3 and 6). Firstly, since it is not possible in reality to explicitly regulate every single affair in the accounting law, the reference to GoB allows to derive accounting rules for not explicitly regulated transactions and helps to fill intended or unintended gaps in the codified act (Baetge and Kirsch, 2002: note 5; Budde and Förtschle, 1988: 43; Leffson, 1987a: 22-23; Moxter, 1986: 7). Secondly, the reference to GoB allows further development of GoB within the frame set by law without actually changing the underlying act and thus helps to flexibly respond to a changing and dynamic business environment (Ballwieser, 1995: 43; Baetge and Kirsch, 2002: note 5; Beisse, 1990b: 500; Haller, 2003: 99; Lang, 1986: 223-224).

Nature, Content and Scope of GoB

Though GoB is an indeterminate concept of law (Leffson, 1987a: 21-22; Kruse, 1978: 104) that has not been defined in the law, consensus exist that GoB do not only relate to bookkeeping (respectively stocktaking) but also to financial reporting in a more general sense (Ballwieser, 1995: 45; Baetge, 1990: column 1815; Baetge and Kirsch, 2002: note 1; Lang, 1986: 222; Moxter, 2002: column 1041; Ordelheide and Pfaff, 1994: 93) also encompassing recognition, measurement and disclosure principles. It seems that over the years with the increasing technical development of bookkeeping systems the emphasis in the GoB discussion shifted from pure bookkeeping issues to financial accounting principles. Moreover, GoB are from their nature not only general bookkeeping respectively accounting principles but can also encompass more detailed accounting principles (Lang, 1986: 222; Leffson, 1987a: 151; Moxter, 2002: column 1041; Moxter, 2003: 9). Regarding their nature *Haller* (2003: 99-100) distinguishes between three different types of GoB: Basic accounting principles and assumptions, detailed accounting principles solving specific issues not covered by codified rules, and interpretations of codified regulations. With the implementation of the Fourth Directive several elements of GoB, primarily basic principles and assumptions, were codified (see appendix), which

means there are codified as well as non-codified Grundsätze.¹⁵ Nevertheless, being an undetermined concept it sometimes still can be difficult to ascertain whether a principle constitutes part of GoB or not (Baetge and Kirsch, 2002 note 5).

Irrespective of whether GoB are codified in the HGB or not, they are compulsory legal principles that need to be considered when drawing up financial statements unless departure is allowed by specific legal provisions (Baetge and Zülch, 2004: note 2).¹⁶ However, according to the rule ‘*lex specialis derogat legi generali*’ specific accounting rules supersede more general principles, but only after the specific reporting rule has been interpreted by considering more general principles as for example GoB (Budde and Förchle, 1988: 43). Therefore, in case of any conflicts between codified specific rules and codified GoB, the specific financial reporting rule takes precedence over the more general principles of orderly accounting (Baetge and Kirsch, 2002: note 113;). Similarly, any specific provision codified in the HGB take precedence over codified and non-codified GoB (Baetge and Kirsch, 2002: note 113). GoB therefore cannot restrict any specific accounting options included in the HGB (Baetge and Kirsch, 2002: note 114).

Due to GoB-references in the tax code (which aims to achieve fiscal equality) as well as in the HGB’s basic section which is applicable to all businessmen (Art. 243, para. 1 HGB), the prevailing opinion developed that GoB need to be applied by all business enterprises irrespective of their legal type and size, i.e. principles that relate only to specific legal types or sizes of entities are generally not regarded as GoB (Baetge and Kirsch, 2002: note 4; Ballwieser, 1995: 46-50; Beisse, 1990b: 506; Lang, 1986: 223). The same conclusion follows from the teleological deductive development of GoB (see below) which assumes equal financial reporting objectives for all business entities and therefore comes up with a set of GoB applicable to all legal types (and sizes) of enterprises (Leffson, 1987a: 152-154). The true and fair view principle codified in Art.

¹⁵ Some authors conclude that codified GoB are legal requirements which can no longer be considered as GoB (see for example Müller, 1988: 11-12). This is however not the prevailing opinion in the literature.

264, para. 2 HGB applicable only to companies limited by shares and corporate partnerships is therefore, generally not regarded as part of GoB (Beisse, 1990a: 2012; Lang, 1986: 225).

How to obtain GoB

So far a unanimously agreed method how to derive GoB has not been attained. There are mainly three different approaches discussed in the literature on how GoB can be obtained (Baetge and Kirsch, 2002: note 8-28):

- inductive development of GoB,
- deductive development of GoB, and
- hermeneutic development of GoB.

The traditional doctrine regarded GoB as the accounting practice of orderly and honourable businessmen (see above). Correspondingly, according to this traditional view GoB had to be derived empirically, inductively from the accounting practice. However, in reality the orderly and honourable businessman lacks a precise definition (Baetge and Kirsch, 2002: note 11; Coenenberg, 2005: 38) and generally, in practice a single view on appropriate accounting practices does not exist among businessmen (Leffson, 1987a: 118-125). Additionally, businessmen are not neutral, they may act in their own self-interest. Therefore, in practice, inadequate accounting methods may arise contradicting the original accounting purposes intended by the legislature (Baetge and Kirsch, 2002: note 10-11; similar Moxter, 2002: column 1042). Thus to derive GoB from accounting practice can lead to an arbitrary, inadequate body of GoB. The view on an inductive development of GoB has, therefore, to a large degree been given up (Ballwieser, 1995: 45; Baetge and Kirsch, 2002: note 10; Coenenberg, 2005: 38; Moxter, 2002: column 1042; Beisse, 1990b: 502) and the dominant approaches agreed in the literature how GoB should be derived are the deductive and the hermeneutic method.

¹⁶ Art. 252, para. 2 HGB allows for example to depart from specified codified GoB in justifiable exceptional circumstances.

According to the deductive method GoB had to be derived (teleologically) deductively from the underlying financial reporting objectives (Lang, 1986:235; Döllerer, 1959: 1220; Leffson, 1987a: 35). The literature discusses mainly two different approaches (Baetge and Kirsch, 2002: note 12; Müller, 1988: 6-7): (1) the business economics deductive method (*betriebswirtschaftlich deduktive Methode*), and (2) the commercial law deductive method (*handelsrechtlich deduktive Methode*). The first method assumes an unambiguous, consistent and generally accepted system of financial reporting objectives (Müller, 1988: 7). GoB then could be derived from the nature of the underlying matter (*aus der Natur der Sache*), i.e. the nature of bookkeeping respectively financial reporting. This is however, not possible: so far, neither an agreement could be reached in business economics on the objectives of financial reporting nor their ranking (Baetge, 1986: 3; Baetge and Kirsch, 2002: 5). Therefore, the prevailing approach is the second, the commercial law deductive method. In contrast to the business economics deductive method it intends to obtain GoB from the financial reporting objectives underlying the HGB respectively from upper legal principles prevalent in the HGB (Moxter, 1985: 21; critical Schneider, 1983) and not from general financial reporting objectives developed in business economics. But, since the legislator did not explicitly define the financial reporting objectives in the law, this method also requires agreement on the financial reporting objectives and purposes underlying the commercial code (Baetge and Kirsch, 2002: note 15). Broad consensus exists in the literature on the legislature's intention to achieve a balanced protection of the divergent and sometimes contradicting interests of the different groups of financial statement users (*Interessenregelung*) (Baetge and Kirsch, 2002: note 15; Coneneberg, 2005: 13-15). According to the codified principles in the HGB, therefore, financial reporting is not directed towards a single objective but tries to fulfil several, sometimes even contradicting purposes, as for example: to determine realized profits (inter alia to protect creditors by ensuring capital maintenance and protect shareholders from being deprived of their dividends) and to provide useful information for the internal management as well as for external financial statement users (Moxter, 2003: 3-7).¹⁷ Accordingly, to achieve a

¹⁷ Baetge and Kirsch (2002: note 30- 50) identify the following financial reporting objectives:

balanced protection of the diverging interests of financial statement users some accounting rules codified in the HGB are more directed towards the determination of realized profits, others reflect more the information function of financial reporting (Baetge and Kirsch, 2002: note 44). This impairs however the deductive development of GoB, since a dominant financial reporting objective as a basis for deducting GoB cannot be identified. The underlying legal financial reporting objectives reflected in the codified accounting principles of the HGB are neither unambiguous nor consistent, and therefore a logically compelling conclusion on the GoB-system cannot be obtained (Ballwieser, 1995: 46; Baetge and Kirsch, 2002: note 17; Schneider, 1983: 157-158). Accordingly, a teleological deduction of GoB is confined to deriving GoB by achieving general agreement between academics, jurisdiction and accounting practice regarding the balancing of the various financial reporting objectives reflected in the HGB (Baetge and Kirsch, 2002: note 17). In practice the deductive method is also often used to analyse specific accounting methods applied in practice according to their appropriateness (Baetge, 1986: 3). The inductive approach can therefore be regarded as a source of input to the deductive method. Whether an accounting method developed in practice constitutes part of GoB or not is however subject to further verification for example by judges (Baetge, 1986: 3).

The hermeneutic method regards the interpretation respectively development of new GoB as a process of knowledge (Euler, 1996: 11). It can be regarded as an extension of the deductive method (Baetge and Zülch, 2004: note 25). Based on an existing understanding of the issue the interpreter develops a starting hypothesis which with the continuing analysis of the issue will be verified, or further modified after falsification (Larenz, 1975: 185-189). According to the hermeneutic method the following criteria have to be considered for the interpretation of existing and the development of new, non-codified GoB (Baetge and Zülch, 2004: note 23):

- the 4th Directive
- wording and meaning of the commercial code provisions

- the meaning of the commercial code provisions in the context of the HGB
- the genesis of the commercial code provisions
- drafting material and views of the legislature
- the financial reporting objectives codified or supposed by the legislature,
- the objectives of the regarded principle as supposed by the legislature
- financial reporting objectives developed in business economics (objective-teleological determined financial reporting objectives)
- the constitutionality of the principle under consideration.

The hermeneutic development and interpretation of GoB can be regarded as an integral approach. It requires a specific Grundsatz to fit in the whole system of already existing GoB as well as in the whole system of other codified provisions. Like the commercial law deductive method, the hermeneutic approach does not lead to logically compelling conclusions regarding the GoB-system. It rather allows justified decisions on one or more partially or wholly mutually exclusive possibilities, by considering all of the parameters displayed in figure 1 below (Baetge and Kirsch, 2002: note 18-27). Thus, GoB develop in interaction of academe, jurisdiction and business practice (Baetge and Zülch, 2004: note 29).

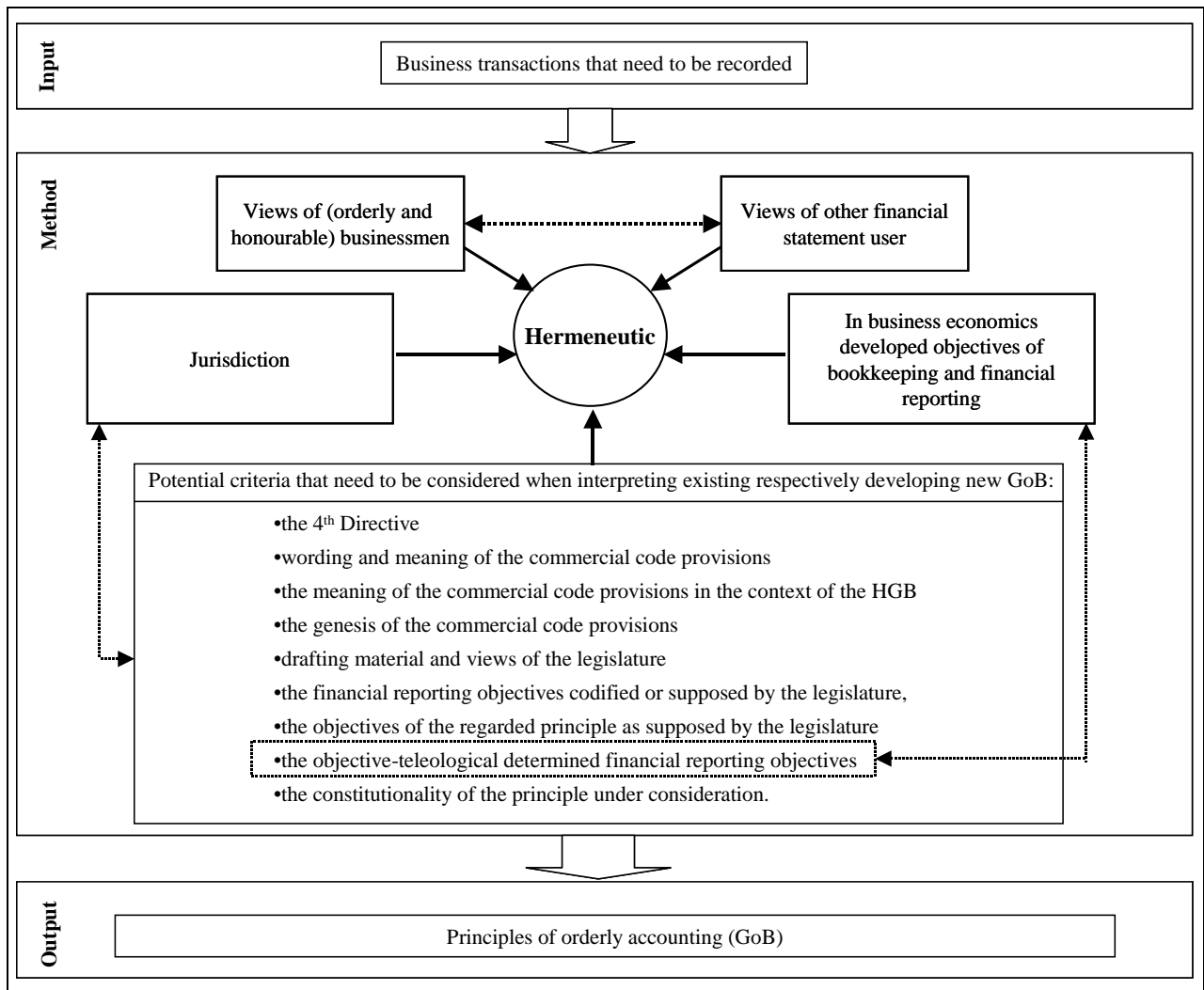


Figure 1: Hermeneutic approach to interpret existing respectively developing new GoB
(Source: Baetge and Kirsch, 2002: 10)

Irrespective of whether a hermeneutical or deductive approach is assumed, in practice the development of new and interpretation of existing GoB does not follow any formalized process. GoB development and interpretation is rather a ‘political’ process influenced by various factors, such as the accounting practice of companies, published opinions in commentaries and journals, recommendations, opinions issued by the auditing profession, court decisions and standards released by the German Accounting Standards Committee (Haller, 2003: 100-104).

Systematization of GoB

Though different approaches have been developed in the literature to systematize GoB (e.g. Baetge, 1986; Baetge and Kirsch, 2002: note 29-112; Euler, 1996; Leffson, 1987a, Moxter, 2002: column 1043-1051) so far an agreement on a specific GoB-system has not been reached (Coenenberg, 2005: 38).

By applying a teleological deductive approach *Leffson* (1987a) developed a hierarchical GoB-system. Based on the major objectives assigned to financial accounting – documentation, accountability¹⁸ and calculation of distributable income (respectively capital maintenance) – he distinguishes between upper and lower principles of orderly accounting (see figure 2).

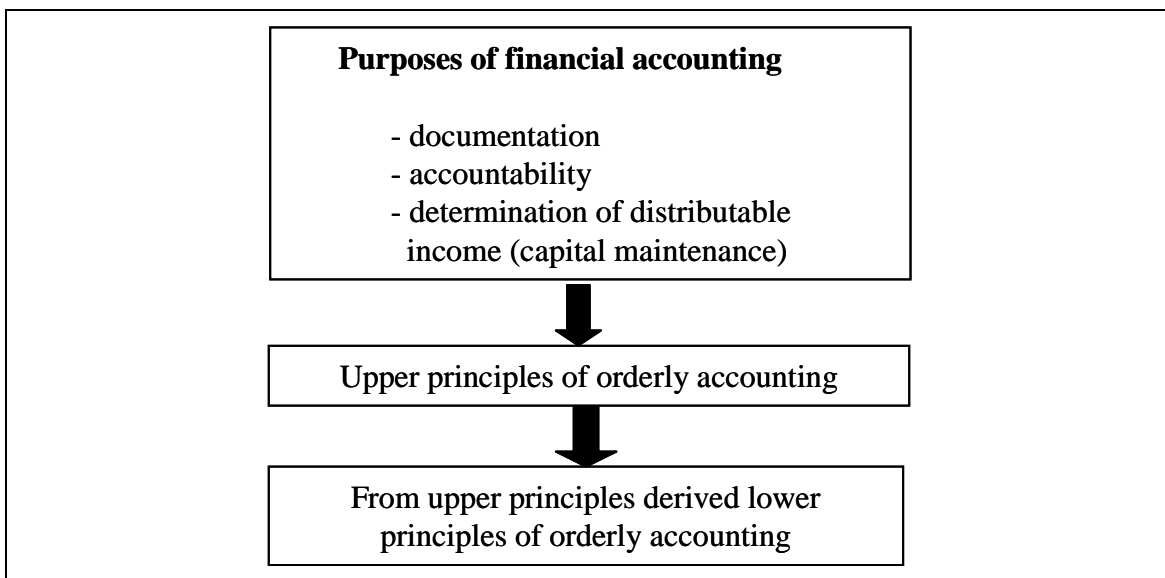


Figure 2: Deductive approach to GoB-development according to *Leffson* (1987)

According to *Leffson*'s GoB understanding upper GoB of accountability (*obere Grundsätze der Rechenschaft*) are (*Leffson*, 1987a: 179):

- principles of accuracy and objectivity

} Framework principles

¹⁸ *Leffson* had a broad understanding of accountability including retrospective as well as prospective information (*Leffson*, 1987a: 63-66).

} (*Rahmungsgrundsätze*)

- principle of clarity
 - principle of completeness

 - realisation principle
 - matching and accruals principle
 - principle of imparity

 - principle of consistency
 - prudence principle
- } Demarcation principles
(*Abgrenzungsgrundsätze*)

} Supplementary principles
(*ergänzende Grundsätze*)

These upper principles are then used to develop lower GoB, i.e. more detailed accounting principles.

Baetge and *Kirsch* (2002) apply a hermeneutic approach (see also *Baetge*, 1986 and *Baetge*, 1990). Based on the financial reporting objectives, documentation (*Dokumentation*), accountability (*Rechenschaft*) and capital maintenance (*Kapitalerhaltung*) – inter alia identified from codified GoB and for which a balanced protection of the divergent interests of all financial statement users is assumed (*Baetge* and *Kirsch*, 2002: note 44) –, they distinguish between (*Baetge* and *Kirsch* 2002: note 56-112; see also *Baetge*, 1990):

- documentation principles: they are primarily related to a proper bookkeeping system,
- framework principles: they serve all three financial reporting objectives, i.e. documentation, accountability and capital maintenance and include for example accuracy, comparability, clarity, completeness, cost benefit consideration, etc.,
- system principles: they establish an unified reference system necessary for a homogeneous specification of lower principles of orderly accounting and include the principle of going concern, pagatoric and item-by-item valuation,
- definitional principles for annual profit/loss: they serve primarily the accountability purpose by ensuring a comparable income calculation; they

include the realization principle, historical cost principle, matching and accrual principle;

- recognition principles for the balance sheet: they explicitly define general recognition criteria for assets and liabilities (e.g. capability of being separated and transferred or sold independently of other assets, etc.)
- capital maintenance principles: they are supposed to maintain nominal capital to achieve creditor protection and the protection of other financial statement users. The principles of capital maintenance include the principle of prudence and the imparity principle.

The following figure 3 gives an overview of the GoB-system developed by *Baetge* and *Kirsch* (2002).

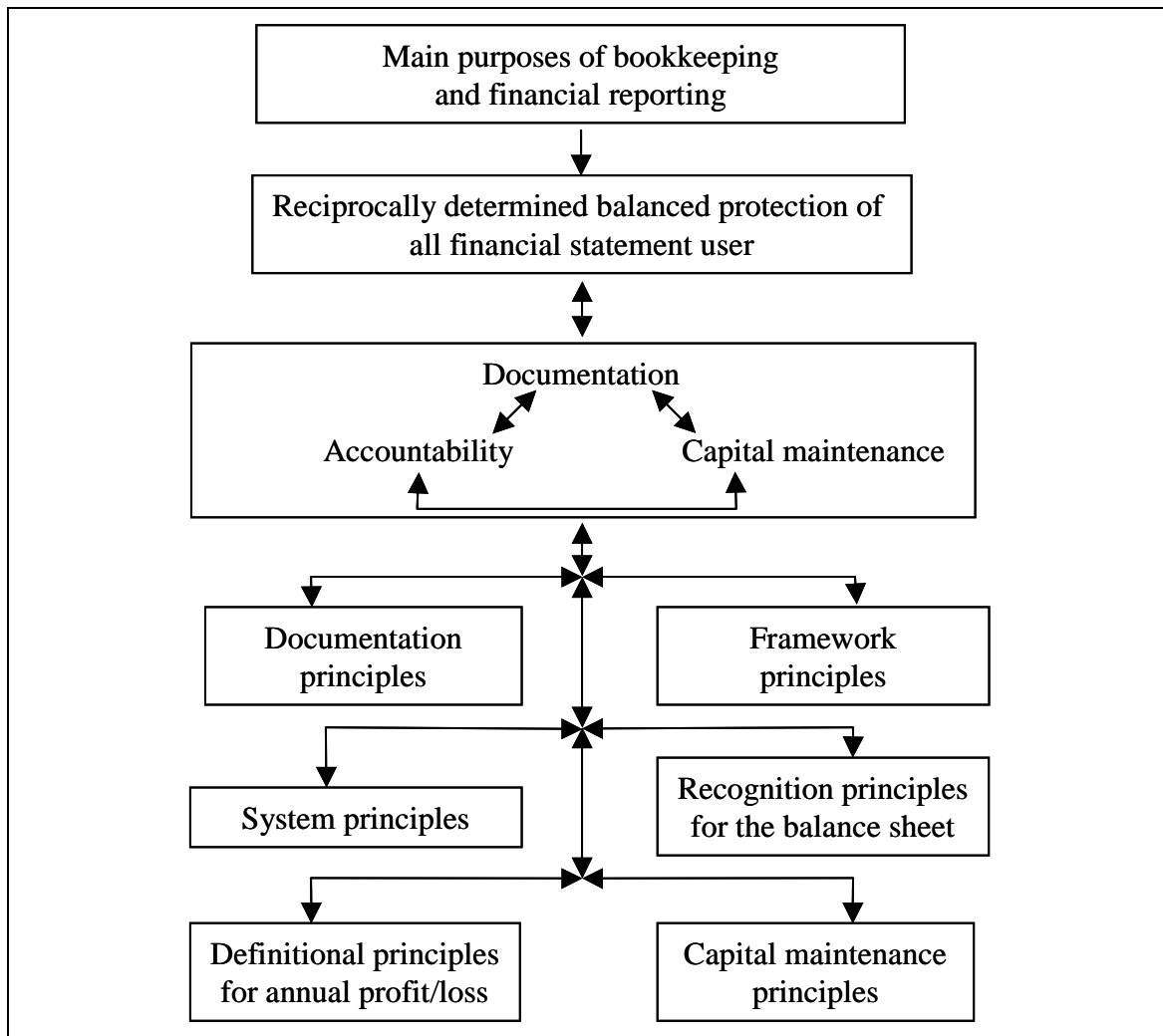


Figure 3: GoB-system according to *Baetge and Kirsch* (2002: 17)

The hermeneutically developed GoB-system of *Baetge and Kirsch* (2002) is not a stringent hierarchical system. The principles in figure 3 are rather in a reciprocal super-respectively subordinate relationship. Though the principles can sometimes even mutually restrict each other, they do not reverse each other. The integrative development/interpretation of GoB leads to an interlocked set of GoB preventing financial statements serving only one single objective in an unbalanced way (*Baetge and Kirsch*, 2002: note 47-50).

In conclusion, therefore, GoB is undefined and, unless the objectives of financial reporting can be reduced to one single purpose, is undefinable.

3 TRADITIONAL BRITISH POSITION: A HISTORICAL PERSPECTIVE OF TFV

Although the actual linkage of the words “true and fair view” did not appear in UK legislation until 1947, the notion these words represent, and the philosophy which underlies them, are ingrained in the British accounting, indeed the British business, indeed the British, psyche. Nobes (1983), and many others, have pointed out the relationship between the flexible and micro-focused UK accounting tradition on the one hand, and the traditions of the UK originated common law system on the other. Since this latter can be traced back to the Norman invasion (1066 and all that), the origins are indeed deep-seated.

Earlier analyses relating to the 1948 Consolidating Companies Act and afterwards are available, e.g. Chastney (1975) and Rutherford (1985). Evans gives a recent summary of this literature (2003:312-3). Alexander (1999) demonstrates the power and implications of the idea by reference to the case of the ‘Royal Mail Steam Packet Company’, as written up at length in Hastings (1962), which, predating 1947/8 as it does, demonstrates also the unimportance of the particular words used to describe the concept (the signified is important, the signifier is not, see eg Walton (1991), Culler (1974)).

Alexander (1999) summarised the case as follows:

The published accounts for 1926 showed a profit of £439,000. The internal accounts for the year showed a loss of some £300,000, and the difference was achieved by crediting the profit and loss balance with £750,000 out of secret tax reserves (published accounts at this time did not prescribe a profit and loss account). The only indication of this highly significant adjustment was the statement, inserted by the auditor, that the profit figure was ‘including adjustment of taxation reserves’. The auditor (and the chairman) were accused of producing a fraudulent balance sheet.

The auditor's line of defence was simple: 'The defence must necessarily turn upon the one question, whether or not the words used by (the auditor) were well recognised in accountancy circles, and were sufficient to give notice of the manner in which the trading loss had been turned into an apparent profit. Whether or not this accountancy practice was to be commended was, in our view, wholly immaterial. The charge we had to meet was a charge of dishonesty, and if it could be shown that (the auditor) had merely adopted the customary practice, it would be very difficult to accuse him of dishonesty' (Hastings 1962).

Alexander (1999) then made an interesting comment, as follows, in relation to how this "customary practice" is to be determined.

What has evolved over time, however, is how 'customary practice' is to be defined and encapsulated, In 1926 there was no doubt. Customary practice was what was usually done, it was a bottom-up philosophy, emanating from individuals – though from individuals who had been conditioned by a similar professional training process.

It is hopefully obvious that the wording of this argument (...emanating from individuals...) is remarkably similar to the phrase used in relation to the 1897 HGB ... "the dominant opinion developed that GoB should be derived inductively from the practice of careful and orderly businessmen". We develop this point later in section 8.

TFV in the UK post 1948

We should begin by briefly stating the formal position, as expressed in Section 226 of the 1985 Companies Act, as inserted by the 1989 Companies Act. This reads as follows.

Duty to prepare individual company accounts

- 1) The directors of every company shall prepare for each financial year of the company –
 - a) balance sheet as at the last day of the year, and
 - b) a profit and loss account

Those accounts are referred to in this Part as the company's 'individual accounts'

- 2) The balance sheet shall give a true and fair view of the state of affairs of the company as at the end of the financial year; and the profit and loss account shall give a true and fair view of the profit or loss of the company for the financial year.
- 3) A company's individual accounts shall comply with the provisions of Schedule 4 as to the form and content of the balance sheet and the profit and loss account and additional information to be provided by way of notes to the accounts.
- 4) Where compliance with the provisions of that Schedule, and the other provisions of this Act as to the matters to be included in a company's individual accounts or in notes to those accounts, would not be sufficient to give a true and fair view, the necessary additional information shall be given in the accounts or in a note to them.
- 5) If in special circumstances compliance with any of those provisions is inconsistent with the requirements to give a true and fair view, the directors shall depart from that provision to the extent necessary to give a true and fair view.

Particulars of any such departure, the reasons for it and its effect shall be given in a note to the accounts.

Auditors are given a corresponding duty to report on this requirement, stating whether in their opinion (note the subjectivity implied by this phrase) the accounts have been properly prepared in accordance with the Acts, and whether in their opinion a true and fair view is given. It should be noted carefully that section 226, subsections (2) and (3) are separate requirements. Since both must explicitly be attempted, it follows that they are independent and that either one could be achieved without the other. In particular:

1. complying with all detailed requirements of the Acts does not necessarily lead to a true and fair view.
2. where such a conflict arises, it is the true and fair requirement which is the more important.

The central issue here is the relationship between this legal position and the role and position of UK Standards as adopted or issued by the Accounting Standards Board (ASB). The True and Fair View (TFV) is a paramount required, and this supremacy leads to the True and Fair Over-ride (TFO), which in principle not only allows, but in necessary circumstances requires, departure from any other requirement, whether that other requirement is legal or otherwise. UK Standards, both before 1990 from the Accounting Standards Committee, and since 1990 from the ASB, have made considerable use of this situation, as we illustrate below.

We look first at SSAP 19 (ASC 1981) Accounting for Investment Properties. Under paragraph 18 Schedule 4, Companies Act 1985, depreciation of fixed assets is a legal requirement.

In the case of any fixed asset which has a limited useful economic life, the amount of:

- (a) its purchase price or production cost, or
- (b) where it is estimated that any such asset will have a residual value at the end of the period of its useful economic life, its purchase price or production cost less that estimated residual value;

shall be reduced by provisions for depreciation calculated to write off that amount systematically over the period of the asset's useful economic life.

The essential requirements of SSAP19 are that investment properties should usually be shown at valuation, but that revaluation differences should be taken to a revaluation

reserve account, not to the income statement. Investment properties should not be depreciated. The Accounting Standards Committee accepted without argument that SSAP19 conflicts with paragraph 18 of Schedule 4. (They do not appear to have considered the possibility of arguing that investment properties are not *fixed* assets.) This problem is cheerfully and quickly solved in paragraph 19 of the SSAP.

The application of this Standard will usually be a departure, for the overriding purpose of giving a true and fair view, from the otherwise specific requirements of the law to provide a depreciation on any fixed asset which has a limited useful economic life. In this circumstance there will need to be given in the notes to the accounts 'particulars of that departure, the reasons for it, and its effect'.

A more recent regulation which, at the time, needed to nullify an explicit legal requirement concerns FRS 10, Goodwill and Intangible Assets (ASB 1997). The requirement for the treatment of positive goodwill and intangible assets is given in paragraphs 15, 17 and 19.

Where goodwill and intangible assets are regarded as having limited useful economic lives, they should be amortised on a systematic basis over those lives.

Where goodwill and intangible assets are regarded as having indefinite useful economic lives, they should not be amortised.

There is a rebuttable presumption that the useful economic lives of purchased goodwill and intangible assets are limited to periods of 20 years or less. This presumption may be rebutted and a useful economic life regarded as a longer period or indefinite only if:

- a) the durability of the acquired business or intangible asset can be demonstrated and justifies estimating the useful economic life to exceed 20 years;
and
- b) the goodwill or intangible asset is capable of continued measurement (so that annual impairment reviews will be feasible).

Impairment is defined in paragraph 2 as

A reduction in the recoverable amount of a fixed asset or goodwill below its carrying value.

The companies Act 1985, Schedule 4 paragraph 21 requires the following.

The amount of the consideration for any goodwill acquired by a company shall be reduced by provisions for depreciation calculated to write off that amount systematically over a period chosen by the directors of the company.

The period chosen shall not exceed the useful economic life of the goodwill in question.

In any case where any goodwill acquired by a company is shown or included as an asset in the company's balance sheet the period chosen for writing off the consideration for that goodwill and the reasons for choosing that period shall be disclosed in a note to the accounts.

The FRS 10 resolution of this clash is brief and succinct (paragraph 18), although the disclosure requirements are carefully specified (paragraphs 55-59).

Companies legislation requires goodwill that is treated as an asset to be amortised systematically over a finite period. Where a company's financial statements depart from this requirement, the departure must be justified as being required for the overriding purpose of providing a true and fair view.

The financial statements should disclose the methods and periods of amortisation of goodwill and intangible assets and the reasons for choosing those periods.

Where an amortisation period is shortened or extended following a review of the remaining useful economic lives of goodwill and intangible assets, the reason and the effect, if material, should be disclosed in the year of change.

Where there has been a change in the amortisation method used, the reason and the effect, if material, should be disclosed in the year of change.

Where goodwill or an intangible asset is amortised over a period that exceeds 20 years from the date of acquisition or it not amortised, the grounds for rebutting the 20-year presumption should be given. This should be a reasoned explanation based on the specific factors contributing to the durability of the acquired business or intangible asset.

In addition, where goodwill in the financial statements of companies is not amortised, the financial statements should state that they depart from the specific requirement of companies legislation to amortise goodwill over a finite period for the overriding purpose of giving a true and fair view. Particulars of the departure, the reasons for it and its effect should be given in sufficient detail to convey to the

reader of the financial statements the circumstances justifying the use of the true and fair override. The reasons for the departure should incorporate the explanation of the specific contributing to the durability of the acquired business of intangible asset required by paragraphs 58.

From a UK legal point of view, the position seems perfectly secure. The true and fair view over-ride reigns supreme according to statute (Companies Act 1985 as amended, paragraph 226).

However from a European legal perspective the position is much less clear. A true and fair over-ride is incorporated in the Fourth Directive, in Article 2, as follows.

1. The annual accounts shall comprise the balance sheet, the profit and loss account and the notes on the accounts. These documents shall constitute a composite whole.
2. They shall be drawn up clearly and in accordance with the provisions of this Directive.
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, additional information must be given.
5. Where in exceptional cases the application of a provision of this Directive is incompatible with the obligation laid down in paragraph 3, that provision must be departed from in order 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 effect on the assets, liabilities, financial position and profit or loss. The Member States may define the exceptional cases in question and lay down the relevant special rules.

The relationship between national and European laws is complicated. It is certainly clear that for the TFV required by the Fourth Directive, “its final interpretation remains with the European Court of Justice” (van Hulle 1997:716). It seems to be generally accepted now that “it is Perfectly possible that annual accounts which are regarded as true and fair in one Member State, would not be interpreted as such in another Member State” (van Hulle 1993). See Alexander (1993) Nobes (1993). “Presumably, the [European] Court [of Justice] wanted to say that when the company concerned correctly applied the national accounting rules, there was no reason for criticism” (van Hulle 1997:716).

In the present context, the key issue is the meaning and implication of the last sentence of article 2(5) of the Directive. The Contact Committee on the Accounting Directives (European Commission 1990:2) argued that the TFV over-ride “must be applied in relation to a given company and not in relation to all companies or a category of companies”. Alexander (1993), Nobes (1993) and Burlaud (1993) all argued that this interpretation is both illogical and inconsistent with the wording of the Directive itself. However, Van Hulle uses an identical sentence four years apart (1993:101; 1997:714): “In order to further limit the cases in which the true and fair override can be used, Member States are allowed to define the exceptional cases and to lay down the relevant special rules”.

It seems probable that a clash of legal systems lies at the root of this difference of opinion. English law takes a positive approach and looks at a law or regulation to seek an understanding of what it means. Roman law takes a hermeneutical approach and looks at a law or regulation to seek an understanding of what it was intended to mean. We return to these issues later in the paper. Certainly the “in order to further limit...” phrase is neither stated nor in any way implied in the wording of the Directive.

It is important to emphasise that, notwithstanding the prevalence of TFV usage relating to the *following* of Standards against statute, individual cases of the use of the concept do occur. Alexander (2001) gives several examples. In summary, therefore, TFV in practice in the UK provides an element of flexibility both for standard-setters against laws, and, in exceptional circumstances, for individual preparers against either laws or standards.

4. REALITY AND ITS REPRESENTATION

The profession must help lay down good rules of the road. Instead of getting mired in the false choice between “rules-based” and “principles-based” accounting, firms need to help craft “objectives-based” accounting. New rules should ensure that the underlying economics of any company are reflected in the balance sheet. FASB should consider – and the accounting profession should support – adopting a rule similar to one the Securities and Exchange Commission SEC has on its books, which obliges companies to disclose any material information that ensures financial statements are not misleading, whether or not that information is specifically required.

(Levitt, 2003)

This quotation is hardly jargon-free. But it addresses an issue both fundamental and topical. What is meant by “the underlying economics” of a reporting entity is necessarily central to any attempt to discuss, or improve, the functional operation of the accounting and reporting function. The whole approach to the construction and specification of accounting regulations and standards is being discussed, indeed disputed, both between nations and within the International Accounting Standards Board (IASB), and within the United States.

There are two crucial questions related to the Levitt quotation. The first one is what are the underlying economics and how can accountants present them (if, indeed, they can present them at all)? The second is what do we mean by “not misleading”? Not misleading to whom, and from what?

If we accept Levitt's proposition that we are trying to “reflect” the “underlying economics” of a company in its financial statements, then we must immediately note that a reflection, or a representation (US), a view (English) or an *image* (image, French) or a *Bild* (picture, German) cannot themselves be the underlying object itself. But what *is* the nature of the underlying object – the real thing. Indeed, in what sense is there a real thing at all?

This problem in accounting has been addressed by a number of writers, including Sterling (1988), Thomas (1969, 1972), Heath (1987) and Mattessich (1995). Mattessich (ch. 3) addresses the question: Is income a mere concept, or does it have empirical reality? He takes exception to criticisms of accounting concepts such as income and stockholders' equity, which have been expressed by writers such as Heath (1987) and Sterling (1988). Examples of such criticisms are: ‘income does not exist in the real world any more than a family with 1.6 children exists in the real world....stockholders' equity is simply a name (Heath, 1987: 2-4); and ‘With rare exceptions accounting numerals do not represent phenomena, *any* phenomena...there are no phenomena that correspond to the numerals that appear on financial statements’ (Sterling, 1988: 4-5).

Mattessich's reply to these criticisms is based on reasoning similar to Searle's (1995) Theory of Institutional Facts and his concept of ‘collective intentionality’. According to Mattessich, social reality is a ‘level’ of reality, to be distinguished from physical-chemical, biological and psychic levels.

To use Searle's terminology, many species of animals, especially humans, have a capacity for *sharing* intentional states such as beliefs, desires and intentions. Thus, in addition to the intentional states of individuals, there are shared or collective intentional states, i.e. collective intentionality (Searle, 1995: 23-26). By virtue of collective intentionality, ownership claims, income, and other conceptual objects of accounting can, under appropriate conditions, be *institutional facts*. Note carefully that this argument only applies, by definition, to those who are willing to be part of the collective.

Institutional facts can only exist for those who are willing and able to accept the institutions.

The question then arises of whether social reality, including institutional facts, can exist independently of our collective representations of them. Searle (1995: 191-194) accepts that they cannot, though he notes that a socially constructed reality such as money presupposes the existence of a non-socially constructed reality such as metal, paper, electronic records, out of which the former is constructed.

Thus, Searle's position is that (a) under appropriate conditions a firm's profit becomes (is objectified as) an 'institutional fact', but also (b) this does *not* mean that profit is real, or has a real-world referent, in the *external realist* sense of existing *independently* of the collective representations which lead under appropriate conditions to its objectification. It does not exist outside the human mind.

But if external realism is rejected as an ontological basis for accounting, we need an alternative basis. We would argue that this is offered by Internal Realism as proposed by Putnam (1981). Putnam (1981: 49-52) described external realism and his alternative to it, internal realism, as follows:

'[According to the perspective of] metaphysical realism, the world consists of some fixed totality of mind-independent objects....Truth involves some sort of correspondence relation between words or thought signs and external things or sets of things. I shall call this perspective the *externalist* perspective...[As regards what] I shall refer to as the *internalist* perspective....it is characteristic of this view to hold that *what objects does the world consist of?* is a question that it only makes sense to ask *within* a theory or description....[S]igns do not intrinsically correspond to objects, independently of how those signs are employed and by whom. But a sign that is actually employed in a particular way by a particular community of users can correspond to particular objects *within the conceptual scheme of those users*. "Objects" do not exist independently of conceptual schemes.'

Thus, according to internal realism, the objects of accounting do not exist independently of a conceptual scheme that relates accounting concepts to each other and to their empirical referents. They do not exist independently of the human mind. But this does *not* mean that such objects are not real. The objects of accounting are part of an *economic reality* that is *socially* (i.e. *intersubjectively*) constructed and objectified by virtue of *collective* intentionality (but only to the extent that such collective intentionality actually exists).

Given the nature of accounting reality as analyzed above, we now need to consider the epistemological issue of what we mean by a truthful representation of such reality. How is 'truth' in financial reporting to be defined? In its definition of 'representational faithfulness' the FASB's *Statement of Accounting Concepts No.2* (FASB, 1980) states that representational faithfulness is 'correspondence or agreement between a measure or description and the phenomenon that it purports to represent'. As in the case of external realism, such a theory of truth in financial reporting, which may be characterized as a correspondence theory of truth, has an intuitive appeal. However, it was shown above by reference to Searle's analysis of *institutional facts* that external realism (as normally understood) is not a suitable ontological theory for accounting.

As Searle (1995: 154) points out, on a normal interpretation a *correspondence* theory of truth implies external reality, since it implies that there is a reality to which statements correspond if they are true. Hence, by contraposition, not-external reality implies not-correspondence theory of truth (on a normal interpretation of the latter). In particular, internal reality (a form of not-external reality) is incompatible with a normal interpretation of correspondence theory of truth. Given that Searle (1995:191-194) rejects an external reality position on social reality, logically he should also reject a correspondence theory of truth (as normally interpreted) in the same context. Thus, the argument above implies the need for a different theory of truth in accounting. Indeed, it leads towards Putnam's view of truth (Putnam, 1981: 50):

Truth in an internalist view, is some sort of (idealized) rational acceptability – some sort of ideal coherence of our beliefs with each other

and with our experiences *as those experiences are themselves represented in our belief system* - and not correspondence with mind-independent or discourse-independent “states of affairs” (emphasis in original)

To distinguish it from a correspondence theory of truth, such a theory of truth may be called a Coherence Theory.

The contrast between ‘coherence’ and ‘correspondence’ as theories of truth in accounting may be illustrated by reference to Warren S. Buffet’s now celebrated set of Socratic questions about the accounting treatment of stock option compensation plans (Zeff, 1997):

If stock options are not compensation, what are they?
 If compensation is not an expense, what is it?
 If an expense should not be included in the income statement, where should it go?

Buffet’s implied criticism of the proposal to exclude the value of stock option compensation plans from the amount of compensation expense reported as such in the income statement does not seem to be a criticism made on the grounds that the proposed treatment *lacked correspondence to some external reality*. Instead, it is more easily understood as a criticism made on the grounds that the proposed treatment *lacked coherence* with our shared beliefs as to what constitutes compensation and how compensation should be reported in financial statements.

The above philosophically-grounded arguments are based directly on, and are further developed in, Alexander and Archer (2003). But the use that we need to make of these arguments here is different to the thrust of that paper. Our focus here is on the approach to the creation of accounting regulations. The essential point is that the “underlying economics of any company”, as a “reality”, cannot exist independently of a conceptual scheme agreed between human actors. It necessarily follows that a representation of that “reality” which is regarded as having a reasonable correspondence to that reality by those

who *do* accept the relevant conceptual scheme, may not be so accepted by those who do *not* accept that conceptual scheme.

5 WHAT IS THE IASB'S PHILOSOPHY OF STANDARD SETTING?

In this section, we briefly discuss two issues in the context of the IASB: the over-ride question and the principles/rules question. Both are crucial to the focus of this paper. We consider the recent history at the International level. This informs, and provides an up to date general context for, our considerations of current and likely future UK and German developments.

Alexander (1999), further developed by Nobes (2000) and Alexander (2001), distinguishes three different levels of regulation, which are summarized in Table 1.

Type A and Type B ideas are both generally regarded as principles, but there is clearly a distinction between them. Further, there are degrees of “principle-ness” even within Type B. A schematic version of the essential concepts of the IASB Framework is shown in Figure 4. The hierarchical nature of this structure is explicit. Some of the principles are more general, or more “principle-ish”, than others. Reliability and prudence are both presented as Type B, but one is a subordinate contributor to the other. Matching is an “underlying assumption” but reliability is a “qualitative characteristic” according to the IAS Framework. It is important to realize that the word “principles” is used with a whole spectrum of precise implications.

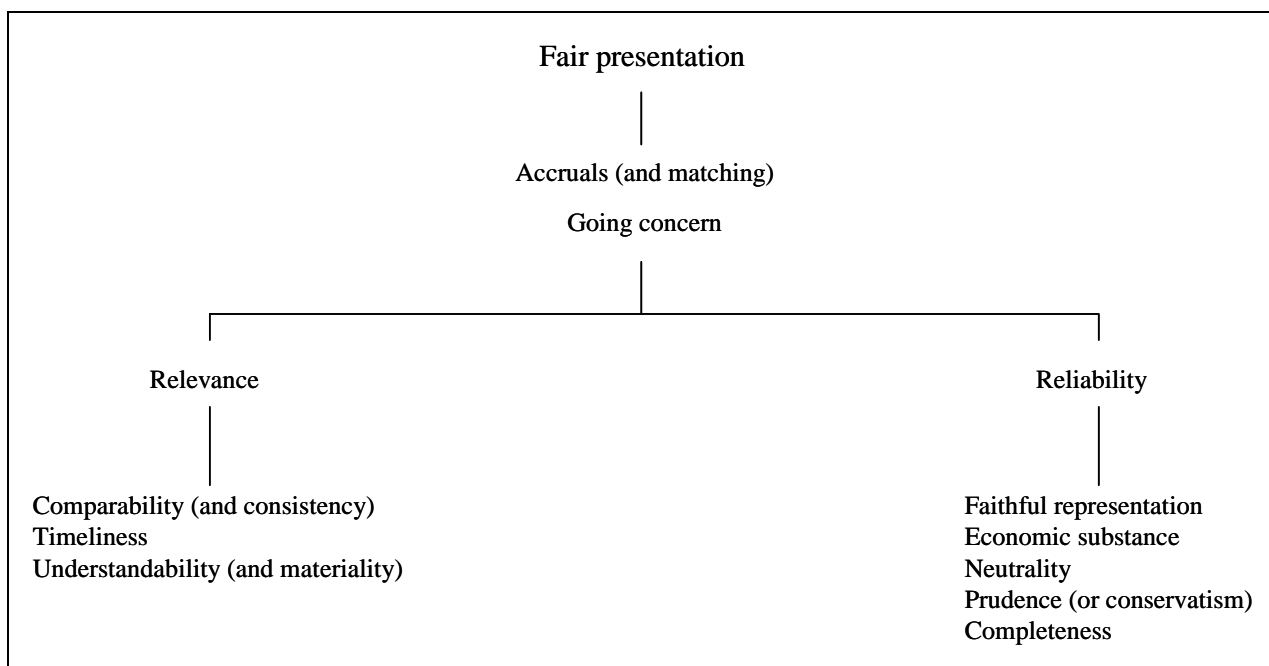


Figure 4: Simplified schema of IASB concepts

A similar point applies to the Type C rules. It seems reasonable to suggest that the requirement in the European Fourth Directive that “fixed assets with a finite useful life shall be depreciated” is a *rule*, being an application of the *principle* of matching. But clearly “motor cars used as fixed assets shall be depreciated at 25% per annum on the straight line basis assuming zero scrap value” would be a significantly more detailed (rule-ish) rule.

Type	Content	Examples
A	A generally expressed all-pervasive fundamental concept	True and fair view, fair presentation, reflection of the underlying economics, nonmisleadingness.
B	A set of notions, conventions or ways of thinking which are to be consistently applied to situations both familiar and unfamiliar	US Statements of Financial Accounting Concepts (FASB) UK Statement of Principles (ASB, 1999) and the IASB Framework (IASB, 1989)
C	The detailed provision of specific methods for the treatment of all expected problems and situations	The French <i>plan comptable</i> , German company laws together with tax regulations, a Soviet

		style chart of accounts and related instructions and forms, and the US GAAP hierarchy.
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Table 1. Three Levels of Accounting and Financial Reporting Regulation

Nobes (2005a), discussing the distinction between principles and rules, fails, like us, to provide good dictionary-type definitions, but explicitly refers to Alexander's (1999) Type A and Type B requirements as being principles, and the Type C as being rules. He states that (2005a:26)

The use of the terms “principles” and “rules” seems broadly consistent among Alexander (1999), Nelson (2003), Schipper (2003) and [Nobes (2005a)].

We accept this statement, though perhaps with an “emphasis of matter” on the inclusion of the word “broadly”.

It is important to note that there are *three* possible views concerning the true and fair concept (or any other Type A concept for that matter). These are:

- 1) It has no meaning, and no effective existence.
- 2) It is important, as a catch-all *addition* to detailed regulations.
- 3) It is important as an addition to, and if necessary an overriding alternative to, detailed regulation.

The implementation of the TFV legal requirement in the EU Member States has been complicated by differences in their legal and accounting systems, as well as by translation challenges. Article 2(3-5) of the Fourth Directive has been transposed in the national legal systems of the EU Member States in different ways. In particular, the

override clause has not been transposed in the legislation of Germany, Austria and Sweden (EC 1998a and 1998b), and see Section 2 above.

The view that US financial reporting regulation in the 20 years or so up to 2000 was focussed on detail has been widely argued. See for example Alexander (1999), Zeff (1995), Benston (2003) and Alexander and Archer (2000). The practical situation was that “present fairly in accordance with [US] GAAP”, meant “follow US GAAP”, where GAAP meant the regulatory hierarchy specified in SAS 69 (AICPA, 1992). US auditing philosophy seems less clear-cut on the matter, under rule 203 of SAS 69, but the “rules” were, as far as practical financial reporting is concerned, supreme. See for example Van Hulle (1997), discussing the creation of the 1997 version of IAS 1.

.... Canada and the United States came out strongly against the override. [They] were not in favour of the override because they feared abuses ... The representative of the SEC argued that – although there is an override test in the auditing standards in the US – *no* registrant with the SEC had *ever* applied the override in its financial statements (emphasis added).

Sir David Tweedie, then chairman of the UK ASB, made his view of the debate quite alarmingly clear, according to Accountancy (1997, August, 17).

IAS1, *Presentation of Financial Statements*, was approved but not without the usual argument over the true and fair override which has been left in the standard. Essentially the US, Canada and Australia do not believe in it but the UK and most European countries do. The SEC’s Mike Sutton made his disapproval of the final standard clear at the meeting, though he had already written to the IASC to say that the true and fair override was unacceptable to SEC staff. “Are you prepared to sign off accounts that you know are wrong?” Sir David [Tweedie] asked the US. “They said yes because that’s what the rules say, and we were just rolling around on the floor at this stage – it’s bizarre what the US does.”

The apotheosis of this US approach is of course the Enron story. Complex rules relating to the creation, and non-consolidation, of special purpose vehicles permitted Enron both to inflate revenues and to hide borrowings as far as the consolidated accounts were concerned. The labyrinthine nature of such detailed rules is wonderfully illustrated by a US publication of the period (Williams et al 2000:11.15) which, by its very volume, is too long to quote.

Benston (2003), giving an American view (with some advantage of hindsight), is forthright.

When some scandal uncovered financial accounting that appeared misleading or inadequate, public, press, and political criticism led to more rules. The FASB, in turn, was established to write such rules, and it did so assiduously. Its propensity to develop rules with extensive and detailed illustrations, interpretations, and instructions resulted, I believe, from its having both a large budget and a professional full-time staff. GAAP then develop into a set of specific rules, not unlike the tax code, which must be followed to the letter, but not necessarily (or at all) according to its intent.

The danger having been recognised, consideration of change emerged. The US situation since 2000 is complex, and of course ongoing. No attempt at comprehensive coverage can be made here, but some important points can be highlighted through quotations. The outcome is extremely important for the future of international reporting, and indeed for the coherence and validity of the IASB.

The FASB (2002) quotes Tweedie (as chairman of the IASB) as testifying before a US Senate Committee as follows:

We favour an approach that requires the company and its auditor to take a step back and consider whether the accounting suggested is consistent with the underlying principle. This is not a soft option. Our approach requires both companies and their auditors to exercise professional judgement in the public interest. Our approach requires a strong commitment from preparers to financial statements that provide a faithful representation of all transactions and a strong commitment from auditors to resist client pressures. It will not work without those commitments. There will be more individual transactions and structures that are not explicitly addressed. We hope that a clear statement of the underlying principles will allow companies and auditors to deal with those situations without resorting to detailed rules. [February 14, 2002].

Schipper (2003), writing in her individual capacity, but being a member of FASB, has a different emphasis.

In this commentary, I have argued that U.S. financial reporting standards are in general based on principles, derived from the FASB's Conceptual Framework,

but they also contain elements – such as scope and treatment exceptions and detailed implementation guidance – that make them also appear to be rules-based. I discuss the effects on comparability, relevance, and reliability of these rules-based elements, with special attention to the effects of detailed implementation guidance. I emphasize that detailed guidance is intended to achieve comparability and pose an empirical question: How much comparability actually exists in U.S. financial reporting? An assessment of the potential sacrifice of comparability that some believe would surely accompany the adoption of principles-based standards requires, first, an understanding of the current state of comparability.

Careful examination of these two extracts makes it clear that Schipper's point of view is different from that expressed explicitly by Tweedie and implicitly by the FASB . Tweedie talks about requiring “the company and its auditors to take a step back and consider whether the accounting suggested is consistent with the underlying principles without resorting to detailed rules”. Schipper argues that US standards are generally *based* on principles and then discusses advantages of having detailed implementation guidance.

Tweedie (2005) reiterates and emphasises the difference in attitude:

It may be that the US says ‘we need lots of guidance’. Well fine – put it in an appendix. We suspect that a lot of auditors will go to the US standards and head for the appendix. But the fact is that you won't have to under international standards – you will be able to use your judgement.

There are signs of US support for a movement towards further judgement and a more principles approach. Pursuant to Section 302 of the Sarbanes-Oxley Act (2002), the SEC (2002) specified the form of wording required by certification, in certain defined circumstances, in a number of situations. That for Form 10-K begins as follows,

- 1 [identify the certifying individual], certify that:
 1. I have reviewed this annual report on Form 10-K of [identify registrant];
 2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to

make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report.

3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report.

There are three key points in this certification. First, achievement of fair presentation in the financial statements is to be confirmed. Second, as an additional and quite separate requirement, confirmation is required that the annual report is not misleading either through an untrue statement *or through omission*. Third, certification that GAAP has been followed is not required. The Section 302 requirement relating to non-misleadingness seems, to us, specifically, and deliberately, undefined. This is the Tweedie version of “principles-based”, not the Schipper version.

More recently, Herz (2005) has argued strongly in favour of a US shift towards the declared IFRS attitude, though he recognises that a contextual shift in the US legal and regulatory infrastructure would need to accompany such an accounting-based change in attitude.

It is surely obvious that fundamental issues concerning the appropriate approach by the IASB as a “philosophy of standards setting” remain to be resolved.

6 RECENT GERMAN DEVELOPMENTS – THE IAS EFFECT

IFRS influence GoB development/interpretation in various ways. The most obvious influence results from the 1998 established German private standards setting body – the German Accounting Standards Committee (GASC), to which have been delegated the following tasks (Art. 342, para. 1 HGB):

- a) development of recommendations on the application of German accounting principles for group accounts,¹⁹
- b) advising the Minister of Justice on relevant accounting issues, and
- c) representing the German Federal Republic on international standard setting bodies.

After the German Accounting Standards (GAS) developed by the German Accounting Standards Board (GASB, the standard setting board of the GASC) in a due process have been published by the Federal Ministry of Justice, there is a presumption of compliance with GoB relating to consolidated accounts if the GAS are applied (Art. 342, para. 2 HGB). The GASC therefore concludes that ‘once the Standards have been published by the Federal Ministry of Justice ... they are presumed to represent German proper accounting principles (GoB) for consolidated financial reporting’ (German Accounting Standards Board, 2005a).²⁰ Thus, although the GASB has no direct standard setting authority to develop GoB, its standards are presumed to represent GoB after they have been published by the Federal Ministry of Justice, however leaving the final decision whether GAS lead to proper consolidated financial statements, or not, to court decisions (Ballwieser, 1999: 443-445; for doubts regarding the constitutional legitimacy of a private standard setting body see Hommelhoff and Schwab, 1998)).

¹⁹ With the adoption of the IAS-Regulation (European Parliament and Council, 2002) EU companies whose securities are admitted to trading on a regulated market of any member state (publicly traded companies) have to prepare their consolidated accounts on the basis of IAS/IFRS. Since the German legislature extended the application of IAS/IFRS by providing an option to do so to those parent undertakings which have no listed securities and therefore are not required to apply IAS/IFRS in their consolidated financial statements (Art. 315a, para. 3 HGB), the GASC changed its standard setting priorities. It now focuses primarily on subjects that are beyond IFRS, as for example the director’s report, as well as on interpretations of issues resulting from national peculiarities not covered in IAS/IFRS (German Accounting Standards Committee, 2005: Preface).

Accordingly, the standards issued by the GASB strongly influence GoB interpretation. Since the GASC was founded to increase flexibility in the development and modernization of accounting principles for group accounts, and in particular to ensure flexible and timely adaptation of national rules to internationally accepted accounting principles (Scheffler, 1999: 407) the GASB's standards are strongly aligned to IAS/IFRS, implying that international accounting principles find their way into GoB.

But Art. 342, para. 1 HGB also raises another issue. So far there hasn't been an explicit distinction in the law between GoB for consolidated accounts and GoB for individual accounts. Art. 297, para. 2 HGB states: 'Der Konzernabschluß ist klar und übersichtlich aufzustellen. Er hat unter Beachtung der Grundsätze ordnungsmäßiger Buchführung ein den tatsächlichen Verhältnissen entsprechendes Bild der Vermögens-, Finanz-, und Ertragslage des Konzerns zu vermitteln' (i.e. consolidated financial statements must be clear and transparent. In accordance with GoB, they have to give a true and fair view of the group's assets, liabilities, financial position and profit or loss). Therefore, at a first glance there seems to be no difference between GoB for individual accounts and GoB for consolidated accounts. But drafting material reveals that with the reference to GoB the legislature also intended to refer to the principles of orderly consolidation (*Grundsätze ordnungsmäßiger Konsolidierung – GoKons*) stating that 'zu den Grundsätzen ordnungsmäßiger Buchführung werden auch die Grundsätze einer ordnungsmäßigen Konsolidierung gerechnet' (Entwurf eines Gesetzes zur Durchführung der Siebenten und Achten Richtlinie des Rates der Europäischen Gemeinschaften zur Koordinierung des Gesellschaftsrechts vom 3. Juni 1985: 35). Moreover, since consolidated financial statements are not the basis for dividend determination and taxation, a deductive or hermeneutic approach could lead to a different interpretation of GoB for consolidated financial statements (Moxter, 1998: 1426; Niehus, 1994). This has however traditionally been rejected in the literature (Ballwieser, 1995: 65). Individual financial accounts and

²⁰ So far all of the GAS promulgated by the GASB have been officially published by the Federal Ministry of Justice.

consolidated accounts are interconnected. Therefore, Art. 298, para. 1 HGB requires – apart from some exemptions (e.g. purely tax driven measurements) – to generally apply for consolidated financial statements the same recognition and measurement principles as for individual accounts. *Ballwieser* (1995: 65) concludes that it was not the legislature's intention that consolidated accounts focus only on providing useful information. Otherwise the legislature would have eliminated the many options available for preparing consolidated financial statements.

Baetge and Zülch (2004: note 104) assume for consolidated financial statements also a capital maintenance function: not by restricting dividend payments but by providing information on the prudent determined profit. They inform financial statement users above which threshold withdrawals reduce the group's capital. The application of equal recognition measurement principles in individual and consolidated accounts also ensures comparability between legal entities and entities organized in a group structure. Additionally, the consolidated accounts are not assumed to replace individual accounts but to provide supplementary information (*Baetge and Zülch*, 2004: note 108-117; *Hommelhoff*, 1999; *Budde and Steuber*, 2000: 973; *Busse von Colbe et al*, 2003: 29). Thus applying generally the same accounting principles in consolidated accounts and in individual accounts does not only decrease the transaction costs for preparers of consolidated financial statements but also those for financial statement users (*Busse von Colbe et al*, 2003: 29). Therefore, to date the prevailing opinion is that GoB developed for single accounts also have to be applied for consolidated accounts (*Baetge and Zülch*, 2004: note 140-143; *Ballwieser*, 1995). Differential GoB have so far been rejected. But due to the increasing internationalisation, differentiation between individual and consolidated financial statements has been regarded as a possible solution (at least short term) to implement international accounting standards without giving up traditional financial reporting objectives such as capital maintenance (restricting dividend payments to protect creditors) and ensuring a close link between financial accounting and taxation (*Eierle*, 2005: 299). To prevent that international accounting practice impacts individual financial statements' objectives, respectively interconnection between individual financial statements and consolidated accounts prevents modernisation and

internationalisation of accounting in Germany, separation between individual and consolidated accounts, and as a consequence development of special GoB for consolidated accounts, is increasingly accepted in the literature (Niehus, 1994; Scheffler, 1999: 413; critical Budde and Steuber, 2000).

One could hypothesise, therefore, that as IFRSs become more all-embracing, and are applied to many more enterprises in and after 2005, the pressure for a divergence and increasing separation between GoB for individual accounts and GoB for consolidated accounts is likely to increase, as long as individual accounts have to serve different purposes from consolidated financial statements.

Up to date the GASB has issued standards relating to:

- (1) accounting issues that are only relevant for consolidated accounts (such as acquisition accounting in consolidated financial statements, accounting for investments in joint ventures in consolidated financial statements, etc.), respectively accounting issues that were in Germany traditionally treated differently in consolidated financial statements and individual financial statements (such as deferred taxes in consolidated financial statements, foreign currency translation, accounting for investments in associates in consolidated financial statements);
- (2) statements that are in Germany so far only required for group accounts (such as cash flow statements, segment reporting etc.);
- (3) disclosure requirements that are generally also relevant for individual financial statements but the GASB restricts the mandatory application to consolidated financial statements but recommends the application also for individual financial statements (e.g. director's report also including risk reporting within the director's report, related party disclosures in the notes),
- (4) voluntary reporting not covered in the HGB and which is therefore not directly within the scope of GoB (e.g. interim financial reporting),
- (5) material accounting issues that are also relevant for individual financial statements but the GASB restricts the mandatory application to consolidated financial statements but recommends the application at least partially also for individual

financial statements (e.g. consistency principle and correction of errors – the rules developed for correction of errors are not applicable to individual financial statements).

Whereas issues covered in (1) – (4) do not directly influence GoB (if GoB are defined in a narrower sense not including the principles of orderly consolidation and being according to the prevailing opinion applicable to all business entities irrespective of their legal type), GAS 13 Consistency Principle and Correction of Errors (German Accounting Standards Board, 2005b) impacts GoB interpretation. The consistent application of measurement methods is codified in Art. 252, para. 1 No. 6 HGB and is considered as codified GoB (see appendix). Formal consistency results from both the principle of clarity (Art. 243, para. 2) and the principle of objectivity (Art. 239, para. 2) which are also regarded as codified GoB (appendix). According to the dominant interpretation, consistency is not supposed with regard to recognition and accounting options relating to recognition (Ballwieser, 2001b: note 102; Selchert, 2002: note 133; Winkeljohann and Geißler, 2006: note 57). This is however in contrast to GAS 13 requiring in compliance with IAS 8 consistent application of accounting policies (including all rules and methods adopted by an enterprise with respect to recognition, presentation and measurement in financial statements as well as rules and methods used for consolidation and decisions on accounting options in these areas). Though the consistent application of accounting policies is only recommended, rather than required, for individual financial statements (GAS 13.3) it seems reasonable that the application of GAS 13 won't remain restricted to consolidated financial statements but will finally lead to a modification of the prevalent GoB interpretation in this area.

Since the GASB is only allowed to issue accounting standards that are in compliance with current accounting legislation, it also makes proposals for changes to existing legislation in cases where it prefers an accounting method that is in conflict with existing

HGB provisions but more in line with international accounting principles.²¹ Accordingly, through these recommendations the GASB tries to bring about legislative changes that are not restricted to consolidated financial statements. In contrast, as the standardisation agreement between the Federal Ministry of Justice and the GASC reveals, an appropriate further development of GoB is anticipated (Scheffler, 1999: 412; Federal Ministry of Justice and German Accounting Standards Committee, 1998). Further development of GoB is also done by advising the Minister of Justice on relevant accounting issues, which is again not restricted to issues relating to consolidated financial statements only (Scheffler, 1999: 409; Schwab, 1999: 735).

But its not only the GASB that causes international accounting principles to find their way into GoB. GoB interpretation/development is also strongly influenced by published opinions of practising accountants, auditors and academics published in commentaries and journals (Haller, 2003: 100). Being more and more exposed to international accounting standards these authors base their opinions increasingly on IFRS or US GAAP especially when they have to deal with accounting problems not covered in the legislation yet (such as stock options (see for example Pellens and Crasselt, 1998)).

GoB are also influenced by the accounting practice especially of large companies (Kuhn, 1997: 310). These often have listed securities and are therefore via IAS-Regulation required to apply IFRS in their consolidated financial statements. Being familiar with international accounting principles they fall back to IFRS also for their individual financial statements for accounting issues not covered in the HGB (Federal Ministry of Justice, 1996: 28-30; Kuhn, 1997: 310)²². This is also pushed by the large accounting

²¹ The GASB for example recommends to abolish Art. 248, para. 2 HGB which prohibits the recognition of self generated intangible fixed assets (German Accounting Standards Board, 2005b: GAS 12.A2).

²² A legal draft issued by the Federal Ministry of Justice in 1996 therefore already proposed to amend Art. 264 HGB saying that in the absence of HGB provisions recognition and measurement principles accepted in other states for preparing financial statements or for getting admission to capital markets may be applied, provided these principles are in compliance with GoB and HGB provisions and they are equally or even better suited to give a true and fair view (Federal Ministry of Justice, 1996). Although this proposed modification of Art. 264 HGB did not receive final acceptance and has therefore not been enacted, it clearly demonstrates the influence of (international) accounting practice

firms which also play an important role in interpreting GoB. *Haller* therefore concludes ‘the internationalisation of accounting firms in Germany has had an impact on the internationalisation of German accounting, not only through auditing but also through the interpretation of German accounting rules’ (Haller, 2003: 100). The international influence on GoB interpretation is also fostered by the fact that being required to prepare IFRS consolidated financial statements, listed parent undertakings have an incentive to align their individual financial statements as close as possible to international accounting standards to decrease their cost for consolidation procedures.

Since IFRS have also found their way into the European accounting legislation, and especially also in the 4th Directive, the EuGH also falls back to IFRS when interpreting Directive requirements (EuGH, Az. C-306/99). This in turn influences court decisions in the member states requiring judges in Germany also to look at IFRS in the absence of detailed accounting rules in the HGB (Boecking, 2004).

It can be noticed that the German legislature in contrast to the British Accounting Standards Board has so far been very reluctant to directly amend accounting rules to achieve convergence with IFRS. Any amendments have so far been primarily restricted to consolidated accounts. Due to the close interconnection between individual accounts and group accounts major reforms of material accounting principles would directly impact capital maintenance and taxation and therefore have not been undertaken so far (Haller and Eierle, 2004: 41-42). International influence on GoB, therefore, mainly results inductively from the accounting practice respectively the standard setting activities of the GASB. Though the GASB commits itself to a deductive approach to standard development (Scheffler, 1999: 412), it is not a government agency; it is a private standard setting body funded by the members of the GASC. Though the GASC does not restrict its membership to financial statement preparers, analysis of membership fees

on GoB development and the support given by the Federal Ministry of Justice. The application of international accounting principles in the absence of HGB provisions in accounting practice was strongly appreciated to further develop GoB, increase accounting harmonization and improve the quality of financial statements (Federal Ministry of Justice, 1996: 28-30).

reveals that more than 80% of the GASC's membership fees come from enterprises, i.e. financial statement preparers (Burger et al 2005: 125-126). This threatens the GASB's independence (Burger et al, 2005: 126) and supports the fear raised in the literature (Moxter, 1998: 1425) that the GASB's standard setting activities can lead to a comeback of an inductive GoB understanding, where GoB is once again related to actual practices, as in 1897.

Additionally, the standard setting activities of the GASB have also changed the nature of GoB. So far GoB have been primarily regarded as principles, not detailed rules. The GAS promulgated by the GASB in contrast include similar to IFRS detailed accounting and disclosure requirements. It therefore seems that with the official acceptance of GAS as GoB, GoB become much more detailed in nature.

7 RECENT UK DEVELOPMENTS – THE IAS EFFECT

As regards the European dimension in general, and the UK position in particular, there have been a number of recent developments. The UK Financial Reporting Review Panel has taken formal legal advice on 'The "True and Fair Requirement" and International Accounting Standards' (Freshfields Bruckhaus Deringer, 2005). It is worth quoting from this advice at some length.

11) The [1985 Companies] Act has been amended by the [European Union] 2004 Regulations. The Act still contains, in sections 226A and 227A, a specific obligation on all companies who do not prepare their accounts in accordance with international accounting standards to prepare their accounts so as to give a true and fair view of the state of affairs of the company (or group). This obligation overrides any obligation to prepare accounts according to existing accounting standards. Sections 226A and 227A apply only to those companies which will continue to prepare their accounts in accordance with the provisions of the Act, so that the true and fair override does not apply to those companies which prepare their accounts in accordance with international accounting standards from 1 January 2005.

12) The 2004 Regulations also amend section 235 of the Act, so that the auditors' report must state whether a company's annual accounts give a

true and fair view in accordance with the relevant financial reporting framework. Under Section 262 of the Act, as amended by the 2004 Regulations, the references to “true and fair view” in section 235 are, for those companies who do not prepare their accounts in accordance with international accounting standards, references to the requirements in sections 226A and 227A that the accounts of a company (or group) give a true and fair view. For those companies who prepare their accounts in accordance with international accounting standards, references to “true and fair view” are references to the requirement under international accounting standards that such accounts achieve a fair presentation (this requirement is further described in paragraph 14, below).

13) The IAS Regulation seeks to maintain the principle that a company’s accounts should be prepared so as to give a true and fair view in two ways. First, any international accounting standard which the Commission is proposing to adopt must satisfy the requirement that it must not be contrary to the requirement for accounts to show a true and fair view of the financial position and performance of an enterprise.

14) Secondly, IAS 1, which was adopted under Regulation 2238/2004, requires companies to “present fairly” their accounts. The requirements as to fair presentation are set out in paragraphs 13 to 22 of Regulation 2238/2004. The application of International Financial Reporting Standards, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation. IAS 1 envisages that it may be necessary for a company to depart from strict compliance with a requirement in an International Financial Reporting Standard, International Accounting Standard or Interpretation. It is specifically stated that departures from a requirement should be extremely rare and should only happen where management concludes that compliance would be so misleading that it would conflict with the objective of financial statements set out in the Framework for the Preparation and Presentation of Financial Statements. IAS 1 provides that in such a circumstance a company “shall” depart from the relevant requirement, but only if the relevant regulatory framework requires, or otherwise does not prohibit, such a departure. When such a departure is required, the company must make certain disclosures, including the nature of the departure and the reasons for it. Where the relevant regulatory framework does prohibit such a departure, a company must to the maximum extent possible minimize the perceived misleading aspects of compliance by making certain specific disclosures. As far as UK companies are concerned, there is nothing in the Act which prohibits any such departure by a company which prepares its accounts in accordance with international accounting standards.

Conclusion

15. IAS 1 requires companies to “present fairly” their accounts. Companies subject to the IAS Regulation (either because they fall within Article 4 or because they choose to use international accounting standards under Article 5) will not be subject to the true and fair requirement as contained in sections 226A and 227A of the Act. Instead, they are subject to a requirement under the relevant Regulations which specifically requires them to comply with international accounting requirements except in extremely rare circumstances. The IAS Regulation provides that international accounting standards can only be adopted if they are not contrary to the principle that the annual accounts and consolidated accounts must give a true and fair view of the assets, liabilities, financial position and profit or loss of the company or group, as appropriate.

16. All other companies will still be required to prepare their accounts so as to give a true and fair view of the state of affairs of the company or group, as appropriate, and of the profit or loss for the financial year concerned.

We should note that the wording of IAS 1 in its current version not only allows the UK to apply an over-ride, but would allow the US, if it was subject to IAS 1, not to do so – surely a triumph of political expediency over principled belief. But there is a more important point. The true and fair view (TFV) referred to in paragraph 15 is the European Directives TFV. The departure from (International) Standards referred to in paragraph 14 to achieve fair presentation relates to the IASB’s fair presentation. The TFV referred to in paragraph 16 is the UK Companies Act TFV. In principle, and legally, these are three different concepts. Whether they will be three different practical concepts remains an open question.

Thus, whether an IAS Regulation can be adopted by the EU is ultimately, presumably, a matter for the European Court of Justice to be decided against the criteria of the (revised) Fourth Directive. Whether such an endorsed regulation has been properly applied has to be decided against the criteria of IAS regulations, presumably, ultimately, again by the European Court of Justice. The UK TFV as in paragraph 16 is probably, or at least logically, a matter for UK courts, against the criteria of UK law and standards.

THE UK Financial Reporting Council (FRC, 2005) is at pains to play down any difficulties. It concludes that despite the introduction of International Accounting

Standards, and “International Standards on Auditing (UK and Ireland)” (think about that title; Orwell would have loved it!):

- the concept of the “true and fair view” remains a cornerstone of financial reporting and auditing in the UK;
- there has been no substantive change in the objectives of an audit and the nature of auditors’ responsibilities; and
- the need for professional judgment remains central to the work of preparers of accounts and auditors in the UK.

The FRC goes on to say:

Departures from accounting standards

The position in relation to departures from accounting standards is substantively the same under the existing UK framework and IAS. Under both frameworks:

1. companies must depart from particular requirements of accounting standards if compliance is inconsistent with the requirement to give a true and fair view or fair presentation.
2. where companies are required to depart from a requirement, they must make similar disclosures including the nature of the departure, the reasons for it and the financial impact.
3. departures are expected to be rare. Under the UK framework, departures from accounting standards, which are contemplated by FRS 18 (paragraphs 15 and 16), are justifiable only “in exceptional circumstances”. Under IAS, departures are expected to be “in extremely rare circumstances”.

It has been said that the use of the ‘true and fair override’ (a phrase that encompasses departures both from accounting standards and from a detailed accounting requirement of the Companies Act) will diminish as a result of the requirement to comply with IAS and that, as a result, companies’ accounts will not show a true and fair view. That is to misunderstand the circumstances in which the true and fair override has been used in recent years in the UK. An analysis of the use of the “true and fair view override” by Company Reporting Limited shows that in 96% of cases where the override was used, the override has been invoked to justify departures from provisions of the Companies Act in order to *comply* with accounting standards – a common example being where

investment property companies depart from the statutory requirement to depreciate their properties so as to comply with Statement of Standard Accounting Practice 19 which requires the properties to be shown on the balance sheet at market value. In the remaining 4% of those cases, the override was used to *depart* from accounting standards, which illustrates the importance that accounting standards now play in ensuring that financial statements give a true and fair view.

‘True and fair’ in the context of International Accounting Standards

Attention has also been focused on the fact that, under IAS, ‘presents fairly’ is construed together with the phrase ‘*in accordance with international financial reporting standards*’. Although the requirement for a ‘true and fair view’ makes no reference to accounting standards, in practice and effect, the legal requirement in the UK has, for many years, been to prepare accounts which give a true and fair view *in accordance with UK accounting standards*.

This was confirmed by Mary Arden QC in her 1993 opinion, reinforcing her 1983 and 1984 joint Opinions with Leonard Hoffmann QC, when she advised that whether accounts satisfy the true and fair requirements is a question of law, but that in considering that question a Court would have regard to evidence in the form of the established practices and views of accountants and which are, to a large extent, represented in the form of ‘accounting standards’.

The FRC believes that, in circumstances where there is more than one framework in use (IAS and the existing UK framework), the inclusion of references to the financial reporting standards used is intended to identify the framework in accordance with which the financial statements have been prepared and is not intended to constrain the preparation or audit of those financial statements.

The validity of this last proposition is plausible, but not certain. Evans (2003:321) proposes the opposite. Perhaps more significantly, Evans quotes US and German sources in support of the view that the IAS 1 override has little, or no, significance. Here, we have quoted UK sources to the opposite effect. Such differences can in principle be rationalized. The essential point is that, as we argued in Section 4, the “underlying economics of any company”, as a “reality”, cannot exist independently of a conceptual scheme agreed between human actors (Alexander and Archer, 2003). It necessarily follows that a representation of that “reality” which is regarded as having a reasonable correspondence to that reality by those who *do* accept the relevant conceptual scheme,

may not be so accepted by those who do *not* accept that conceptual scheme. Thus, for example, British and German commentators may have two different “realities”, neither one being intrinsically more “real” than the other.

8 ZUSAMMENFASSUNG

In essence, we address two questions in this concluding section. The first concerns the roles and effects, in their relevant jurisdictions, of the true and fair view concept (TFV) and Grundsätze Ordnungsmässiger Buchführung (GoB). Do they really reflect the sort of dichotomous practice and philosophy which is implied by Nobes (1983), Nobes (2005b) and indeed almost universally accepted in the literature? The second concerns the implications of our arguments for the process of global accounting harmonisation and the activities of the IASB. We believe that both the generality of our underlying arguments, and the specific “case-study” provided by our detailed Anglo-German investigation, have important and wide-ranging implications.

We believe that we have shown, in sections 2 and 3 above, firstly that GoB are undefined, and secondly that TFV is undefined. The latter point is univervally accepted, but the former is probably less generally understood. Indeed, a surface reading of our section 2 could be taken to provide evidence both for and against. The historical earlier parts of that section clearly indicate that such a lack of definition was the whole point and intention of the legislation. So what should the reader make of our statement on page 13: “Since the phrase TFV is undetermined, the reference to GoB clarifies the meaning of a TFV”, supported by three references, or that on page 15: “the restriction [of the TFV principle via GoB] also intended to increase legal certainty, since an absolute TFV without reference to a specific framework cannot be provided”. To put the point simply: if GoB is undetermined and undefined, how can it be a “specific legal framework” – how can it “clarify the meaning” of TFV or anything else?

The answer, we suggest, is in fact equally simple. It is that Germans had a clear conception *in their own minds* as to what GoB embraced. The phrase, and its important role, had been enshrined in legislation since 1897. The users of financial accounts (mainly creditors, tax authorities and for prudent dividend determination) were well-established and longstanding. Germans *understood* GoB.

A parallel, and very similar, statement can of course be made about TFV in the British context. The British had a clear conception in their own minds as to what TFV embraced. The users of financial statements (crucially current and potential investors) were well established and longstanding. Britons *understood* TFV.

The second similarity to emphasise is that both TFV and GoB are capable of being flexible in their implications over time. Many examples can be provided. We have given one specific illustration in the UK context earlier in section 3 in relation to the Royal Mail case. A similar *approach* to the case today, ie based on “customary practices”, would undoubtedly arrive at the opposite conclusions to that of 1931. Section 6 clearly demonstrates the flexibility and adaptability of GoB, which are now increasingly influenced by international accounting practice.

Our conclusions are directly supported by Ordelheide and Pfaff (1994:108), writing in English.

Seen in the light of their role in the overall system of regulation, the functional interpretation of law and the application of the true and fair view seem very similar. Both are relatively imprecise and thus allow accepted interpretations of their meaning to become established, permitting the development and application of compromise solutions which reflect the interests of different parties. They also enable these solutions to be adapted over time as circumstances change.

Of course, GoB and the functional interpretation together do not only allow flexibility for “accepted interpretations”, they also permit the possibility of disagreement and therefore uncertainty. Van Hulle seems to distance himself from the view that TFV and German philosophy are “very similar” (1997:715).

I must therefore disagree with those who argue that the meaning of the true and fair view concept in the Directives can be reduced to a requirement for a functional (teleological) rather than a literal interpretation of the provisions in the Directives (Ordelheide, 1993:87). It is true that a functional interpretation must be applied to European law and that a literal interpretation of the provisions in the Directives would be inappropriate but the true and fair view concept has a broader meaning as indicated before.

It should be noted that Ordelheide and Pfaff are writing in an explicit German context, whereas van Hulle clearly refers to the Directives, i.e. the European scenario. In broad terms, we find the Ordelheide and Pfaff argument persuasive in the German context. GoB, and the functional interpretation of the law, the former flexible and the latter debatable by definition, may justly be compared in general effect with the TFV as used in the UK.

There are comments in the German literature saying that with or without reference to GoB the true and fair view must always be interpreted in the context of the underlying financial reporting purposes which are in Germany among others capital maintenance and creditor protection. Schulze-Osterloh (1986: 539-540) states:

Diese Bestimmung der Richtlinie gibt den im englischen Recht entwickelten Grundsatz des true and fair view wieder und transformiert ihn damit in europäisches Recht. Dieser Grundsatz wird teilweise so verstanden, dass er als übergeordnete Generalnorm die Grundsätze ordnungsmäßiger Buchführung überlagere. Damit gewönne die Forderung nach dem den tatsächlichen Verhältnissen entsprechenden Bild der Vermögens-, Finanz- und Ertragslage entgegen den bisher angestellten Überlegungen eine eigenständige Bedeutung. Die Behandlung des Grundsatzes des true and fair view im englischen Recht zeigt aber, dass er dieselbe Funktion hat wie der im deutschen Recht gebräuchliche Grundsatz ordnungsmäßiger Buchführung. Es

geht dabei um die Anwendung anerkannter Bilanzierungsprinzipien, die aus den Bilanzierungszwecken abgeleitet werden. ... Trotz des europarechtlichen Bezugs bedeutet § 264 Abs. 2 Satz 1 HGB daher keine Abkehr von den bisher maßgebend gewesenen Zielen des Jahresabschlusses.

[This provision of the Directive describes the true and fair view principle developed in the English law and transforms it into European law. Some understand this principle as a general clause being overriding to GoB. Then the requirement to give a true and fair view of the financial assets, liabilities, financial position and profit or loss would, against the considerations developed so far, gain an independent meaning. But the application of the true and fair view principle in the English law demonstrates that it has the same function as the common GoB in the German law. It is about the application of accepted accounting principles that are derived from financial reporting purposes. ... Despite its relation to European law Art. 264, para. 2, sentence 1 HGB does not imply a rejection of the currently authoritative financial reporting objectives.]

We now turn to our more general question regarding international harmonisation. We believe that the implications are clear. We have argued in section 4 that “economic reality”, and therefore that on which financial statements purport to report, is subjective and can only be regarded as being objectified by a process of agreed collective intentionality, a process which of course fails automatically in the absence of such collective agreement. In our sections on UK and Germany we have shown by example how two different countries, *with two different collective intentionalities* have rationally used flexible mechanisms (TFV and GoB respectively) to successfully achieve those collective intentionalities. In section 5, we have argued that not only is a degree of flexibility, and therefore of lack of definition/determination, inevitable philosophically and logically, but that this need is also recognised by the Board of IASB and (since the Enron debacle) by important players in the US.

The conclusion is, we believe, both necessary and obvious. Harmonisation will not be achieved purely by regulation. The regulatory system needs subjective (though of course controlled) flexibility. It needs to be able to communicate “economic reality” where economic reality is socially constructed by individual communities in individual contexts

and cultures for purposes which in the past have been individual to such context and culture. Only when there is a true single world-wide collective intentionality regarding financial reporting will a single set of global standards lead to practical harmonisation. In our specific case study, only when the attitude, economic, legal and cultural contexts, and user needs of British and German Kaufleute and accountants all become identical would TFV and GoB carry identical messages. This is not going to happen. Supporters of global accounting standards (which includes the present authors), and those who write those standards and create enforcement mechanisms, must recognise this reality, and learn to live with the implications.

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Appendix

Principle		Content
Grundsatz der Klarheit und Verständlichkeit (Art. 243, para. 2 HGB)	Principle of clarity and understandability	Assets and liabilities, income and expenses resulting from business transactions must be unambiguously named and itemized in sufficient detail.
Saldierungsverbot (Art. 246, para. 2 HGB)	Prohibition on offsetting	Assets and liabilities, and income and expenses may not be offset
Grundsatz der Richtigkeit und Willkürfreiheit (Art. 239, para. 2 HGB)	Principles of accuracy and objectivity	The entries in the accounting records and in other necessary records shall be correct and free from arbitrariness.
Grundsatz der Vollständigkeit (Art. 239, para. 2 and Art. 246, para. 1 HGB)	Principle of completeness	All transactions, assets, liabilities, prepaid expenses, deferred income, income and expenses as well as all foreseeable risks have to be recorded.
Grundsatz der Bilanzidentität (Art. 252, para. 1, No. 1 HGB)	Balance sheet continuity	The carrying amounts in the opening balance sheet must correspond to those of the closing balance sheet of the preceding financial year.
Grundsatz der Einzelbewertung (Art. 252, para. 1, No. 3 HGB)	Item-by-item valuation	Assets and liabilities must be measured on an item-by-item basis.
Grundsatz der Vorsicht (Art. 252, para. 1, No. 4 HGB)	Principle of prudence	Performance must be measured prudently, and in particular all foreseeable risks and losses that have arisen up to the balance sheet date must be reflected.
Realisationsprinzip (Art. 252, para. 1, No. 4 HGB)	Realisation principle	Profits shall only be recognised when they have been realised at the balance sheet date, i.e. the risk of ownership has been passed on to the buyer. This is normally the case when the goods have been delivered or respectively the service has been rendered.
Anschaffungswertprinzip (Art. 253, para. 1 HGB)	Historical cost convention	Valuing assets above their historical cost is not allowed.
Imparitätsprinzip (Art. 252, para. 1, No. 4 HGB)	Principle of imparity	Expected or unrealised losses have to be recognised, even if not realised at the balance sheet date (in contrast to unrealised profits)
Grundsatz der Periodenabgrenzung (Art. 252, para. 1, No. 5 HGB)	Matching and accruals principle	Income and expenses attributable to the financial year have to be recognised irrespective of the timing of the corresponding payment.
Grundsatz der Fortführung der Unternehmenstätigkeit (Art. 252, para. 1, No. 2 HGB)	Going concern	For measurement purposes going concern must be assumed, unless there is constructive or legal evidence to the contrary.
Grundsatz der Stetigkeit der Bewertungsmethoden (Art. 252, para. 1, No. 6 HGB)	Consistency	Measurement methods applied to the preceding financial statements must be retained.

Figure 1: Essential GoB codified in the basic section of the HGB (Coenenberg, 2005: 39-48 and Müller, 1987: 400-401 in combination with Fey and Fladt, 2006: E 4-E 9).