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Semiotics, Hermeneutics and Cash: An Essay on the True and Fair View

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Despite three decades of regulatory efforts in global accounting to promote the hoary true and fair principle (dating to 19th century Britain), it remains an elusive touchstone; despite the cash flow statement's relative infancy (25 years old in the US and younger than 5 in Europe) and comparatively little regulatory investment promoting it, the cash flow statement is emerging as the unifying talisman of global accounting. The connection between the true and fair view and the cash flow statement is a hidden gem among the roughage contained in the US Sarbanes-Oxley Act of 2002.1 The gem creates an opening to address the largest contemporary problem for global accounting: that one array of important principles (Anglo-American) is designed for capital markets whereas another array (Euro-Japanese) is not.2

The early solution to the problem of competing accounting systems, contained in the European Union's Fourth Directive in 1978, called for preparing financial statements that give a true and fair view of a company's condition and results.3 This turned out to be less a solution than a step towards finding one. The semiotic challenge was too great to make it a solution. True and fair balance sheets and income statements signify different qualities in different contexts within the UK and the US. Differences amplify

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1 Public Company Accounting Reform and Investor Protection Act of 2002, 107 Pub. L. No. 204, 116 Stat. 745, § 302. The Act is popularly known in the US as the Sarbanes-Oxley Act and abroad as SOX, and given the international context of the present article, SOX will be used.

2 The designations Anglo-American and Euro-Japanese are shorthand references to systems in place, respectively, in (a) the United Kingdom and the United States of America or derived from them and (b) Japan and the majority of leading European countries such as France, Germany, Italy, Denmark and Sweden, though not including the Netherlands. These classifications are deliberately general, for substantial differences in background culture and particular accounting principles endure between countries within these broad groups. *E.g.*, John Blake, Oriol Amat & Catherine Gowthrope, International Accounting Harmonisation: A Comparison of Spain, Sweden & Austria, *Universitat Pompeu Fabra* Economics Working Paper 294 (Aug. 10, 1998) (available from ssrn.com). More precise cultural gradations would recognize categories such as Romanic, Germanic and Nordic, and finer gradations yet are useful in certain contexts.

3 By early I mean in reference to the precursor period of globalization, when contemporary efforts towards harmonization of global standards in a variety of fields began in earnest.

across systems. What's true and fair in France or Japan is quite different and what's true and fair in Germany different yet again.

One solution to the semiotic challenge is hermeneutic, an argument that a country's corporations can adhere to their nation's methods of computing book value and net income provided supplemental disclosure enables a reader interacting with the entire set of financial statements to create a hermeneutic circle that produces a true and fair view. This hermeneutic response, typified by certain German accounting scholars, ducks rather than solves the semiotic challenge. It leaves unaddressed the relativity of true and fair as a concept when used to describe accounting fidelity. The hermeneutic circle may yield a true and fair view, but that view remains in the eye of the preparer whose outlook varies across countries and contexts. Financial statement readers cannot close this circle.

Another solution to the semiotic challenge of harmonizing the true and fair to develop global capital market accounting is to split a country's internal accounting systems. This is the response epitomized by France, which permitted its multinational companies to follow international group accounting principles instinct with Anglo-American interpretations of the true and fair view. Three bodies of French accounting evolved: (1) individual accounting, (2) domestic group accounting (both adhering to traditional French accounting law) and (3) multinational French accounting (absorbing Anglo-American traditions). Leading French accountants lament that this solution produced fragmented anarchy within French accounting.4

Ultimate answers to the semiotic challenge remain elusive—though many countries such as Spain continue to struggle toward finding a comprehensive solution. But the most immediate partial solution rests not in hermeneutics, anarchy or struggle, but in cash. The cash flow statement—a relatively recent innovation in the history of accounting5—is unbiased by traditional accounting systems, whether those are designed for capital market participants or other purposes.

Under any accounting system, earnings and book values can be measured and reported in innumerable ways depending on the system's goals (or the accountant's ingenuity). Cash is not subject to such vagaries. The content and format of the cash flow statement, moreover, is virtually identical in all major countries—a unique achievement in global accounting. It gives a true and fair without requiring effort to produce the picture, let alone to define the concept and generate international agreement on how to apply it. Ironically, the true and fair view requirement has not typically been applied to include the cash flow statement.

While the semiotic challenge has faced global accounting since at least the Fourth Directive in 1978,6 the stakes rise amid globalization. SOX amplifies them by requiring

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4 Jacques Richard, French: Group Accounting, in 2 Dieter Ordelheide & KPMG, Transnational Accounting (2d ed. 2001), at 1144.

5 Its predecessor, the funds flow statement, dates to the 19th century in Britain, and was adopted by international standard setters in 1977. But its evolution into the cash flow statement did not occur until the 1980s and it was not until the late 1990s that major countries including Britain, Germany, France and Japan widely adopted it. *See infra* text accompanying notes xx-xx.

6 The semiotic challenge antedates the Fourth Directive. The struggle endured within countries such as the UK and Australia following the tradition and some international

top managers to certify that financial statements "fairly present" a company's condition and results. This embrace of the fairly presents standard is nothing new for US accounting, though requiring top officers to specifically attest that a company's financial statements and disclosure meet the standard is new.

The SOX certification standard agitates debate in global accounting concerning the true and fair view because some 1400 SEC registrants are non-US entities (about 10% by number and 20% by capitalization of all SEC registrants).7 While SOX does not require the certification to cover the cash flow statement, SEC regulations implementing SOX do.8 Accordingly, SOX's elevation of the fairly presents standard to officer certificates and the SEC's extension of it to cash flow statements connects debate concerning the true and fair view with the evolution of cash flow statements as both go forward in a globalized capital marketplace.9

The cash flow statement cannot solve all problems of global accounting, but it can produce uniform information concerning liquidity, solvency, credit capacity, performance, and even value. This information is vital to capital market participants. Cash flow data have the premier virtues of comparability across countries and accounting systems while simultaneously and uniquely bearing consistency with otherwise disparate national standards.

Accordingly, more intellectual and normative firepower should be wielded to study and exploit the role and possibilities of the cash flow statement in global accounting, auditing, and finance. The true and fair view struggle need not be abandoned, but it may turn out to be a struggle worth less firepower than once seemed the case. Put differently, the cash flow statement offers the best short-term prospects for global accounting harmonization, while the true and fair is at best a long-term project.

I. Roots of the Issue

The contrasting accounting systems in the US/UK versus Europe and Japan are ultimately rooted in the common law versus civil law traditions prevalent in the cultures.10 US GAAP and British accounting11 draw authority from the fact of being

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effects ensued from the struggle. But the catalyst rendering the challenge global in scope was the Fourth Directive and the environment of nascent globalization that marked its era.

7 *See generally* Lawrence A. Cunningham, US Corporate Regulation as Part Foreign Policy amid Globalization (manuscript, 2003).

8 *See* Securities and Exchange Commission, Certification of Disclosure in Companies' Quarterly and Annual Reports, Release No. 33-8124 (Aug. 28, 2002).

9 Many SOX provisions are headed for SEC exemption in the globalized world. While this provision is not slated for broad exemption, awarding one would not affect the link SOX draws between the fairly presents standard and the cash flow statement..

10 *E.g.*, Blake, et al., supra, , at 19 (citing Pereda J. Tua, *Los principios constables de la regulacion professional al ambito internacional*", *Revista Espanola de Financiacion y Contabilidiad*, (Jan-Apr. 1985), at 48 (referring to differences between UK and Spanish accounting as "controversies whose origin is not other than differences between Continental and Anglo-Saxon law").

11 The term GAAP is not customarily used in Britain to describe generally accepted accounting principles there. *See* David Alexander & Simon Archer, eds., Miller

generally accepted, promulgated chiefly by practitioners of the professions;12 accounting principles in Japan and most continental European countries (the Netherlands is the major exception) draw their legitimacy from law, not general acceptance.13 The split produces greater flexibility and requires judgment on matters of substance among Anglo-American accountants while emphasizing greater constraint and a focus on processes among Euro-Japanese accountants.14

The content of articulated accounting principles also differs across these cultures due to varying conceptions of corporate purpose. Traditional Anglo-American corporate purpose is to generate shareholder profits. Financial statements are prepared to reflect performance measured by current profits and financial condition useful to gauge future profit potential. Tax accounting is substantially an independent body of law that uses different conventions to calculate different bottom-line figures.

Euro-Japanese corporate purposes are more variable, but tend to share a broader conception that encompasses promoting interests of constituents other than shareholders, including lenders, employees, and the state. Hence financial reporting and tax reporting tend to be co-extensive. In the audience for whom accounting is conducted, lenders enjoy a privileged seat compared to equity holders. Particularly among Germanic corporations, long-term financial durability is elevated above short-term profits.15

Corporate finance structures reinforce these differences in accounting's goals.

European Accounting Guide (3d ed. 1998), at 1143.

12 This is also the case of Dutch accounting. Though the Netherlands otherwise follows a civil law tradition, it has developed commercial and company law provisions through a specialized court called the Company Division of the Court of Appeal. *See* David Alexander & Simon Archer, eds., Miller European Accounting Guide (3d ed. 1998), at 700.

13 David Alexander & Simon Archer, eds., Miller European Accounting Guide (3d ed. 1998), at 1-2.

14 These characteristics of traditional conceptions and approaches to matters of accounting remain significant even as methods of interpretation between common law and various civil law traditions blend or overlap. *See* Carl Baudenbacher, Some Remarks on the Method of Civil Law, 34 Tex. *Int'l L.J.* 333, 337 (1999) (rich evaluation of common law versus civil law methodologies (and variations within the latter across selected countries) and their mutual contributions to one another, and noting that the "true and fair" brings to civil law traditions a distinctly common law idea).

15 *See* Wolfgang Ballwieser, Germany: Individual Accounts, in 2 Dieter Ordelheide & KPMG, Transnational Accounting (2d ed. 2001), at 1241:

> Besides protection for the equity and debt holders, financial reporting, especially when published, also ensures continued existence of companies, especially large limited companies, as a going concern. The public interest is involved in the fortunes of companies which are so large that their failure would have repercussions on whole sectors of industry and whole areas of the country. Since commercial accounting and tax accounting are interrelated, it is also the national interest that is being safeguarded, as well as that of the regions and municipalities which also benefit from the tax yield.

Anglo-American finance is more heavily oriented towards equity and public capital markets. Equity owners tend to be dispersed and uninvolved in corporate governance, putting a premium on transparency in financial reporting. Euro-Japanese finance historically is more reliant on banks and banks play a central role in corporate governance, making financial reporting opacity tolerable. Coupled with the direct role of employees in corporate governance, banks and corporate management may prefer such opacity.

German law and practice consciously permits and often requires on a wide scale what would be considered earnings management in the US or UK. (It is followed by numerous other European countries from her fellow-Germanic states Austria and Switzerland; the Nordic states of Denmark and Finland; and to lesser and varying degrees by the Romanic state of Spain.) The best-known example concerns hidden reserves.[16]

Hidden reserves refers to the practice of designating what would be considered profits under Anglo-American accounting as reserves that can be drawn on in future years. They appear as neither assets nor liabilities on a balance sheet nor as earnings on an income statement. The effect is a reduction in Anglo-American profits in flush years and an increase in that measure in lean years. In some cases, creating such reserves is compulsory, funding reserves at annual rates up to defined statutory maximums.[17] This deeply-rooted "prudence principle" is designed to protect creditor interests and to sustain the corporation's survival.[18]

Less-well-known examples abound. All leases may be treated as off book under German bookkeeping,[19] whereas US GAAP imposes an elaborate set of rules intended to distinguish between capital and operating leases and restrict the ability to leave leases off the balance sheet.[20] German bookkeeping and US GAAP both require disclosure of related party transactions, but in Germany this category does not include the company's directors.[21] German bookkeeping permits accruals for loss contingencies, precisely to smooth income.[22] Legal capital rules in the US and Germany are intended to protect creditors, but the rules in the US vastly favor shareholders compared to those in

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16 Under German law, management is entitled to allocate to "free reserves" up to 50% of net annual earnings, reduced by obligatory funding of "legal reserves." The corporate articles may authorize managers to allocate to free reserves up to 100% of earnings-after-legal reserves. The net effect is the pool available to draw dividends is far smaller in Germany than in the US. The German reserves, moreover, are available to absorb losses in subsequent years. Together, the reserves build a financial reservoir around the German corporation, intended to enhance its survival. These moats may not be reduced by distributions to shareholders. *See generally* Enno W. Ercklentz, Jr., 2 Modern German Corporate Law (1979), at 440-464.

17 Donald E. Kieso, *et al*., Intermediate Accounting (10th ed. 2001), at 826.

18 . Wolfgang Bellweiser, *supra*, at 1241.

19 Kieso, *supra*, at 1202.

20 US GAAP on this issue is consistent with IASC standards. *Id*. at 1203.

21 Donald E. Kieso, *et al*., Intermediate Accounting (10th ed. 2001), at 1387. Italy is similar to Germany in this regard; Switzerland does not require related party transaction disclosure at all. *Id*.

22 *Id*., at 672

Germany.23

The key sources of divergence between traditional French accounting and US/UK accounting also relate to the distinctive conception of French corporate purpose and related finance and governance realities. The central role of the state seen in French corporate purpose produced accounting rules geared to government fiscal policies with tax law linked to accounting law. The shareholder orientation of Anglo-American corporate purpose produces income statements classified by function, such as the cost of goods sold, whereas the French state orientation produces income statements that define expenses by statutorily-specified type.24 Traditional French accounting conceives of assets in a patrimonial rather than an economic sense, as interests in tangible property rather than bearing economic value.25

Japanese GAAP is an admixture of various traditions, including US/UK and Franco-German. An English translation of the recognized standards is "generally fair, appropriate, and accepted accounting standards."26 As on the continent, Japanese accounting standards derive principally from law, the Commercial Code and various Ministerial Regulations of the Ministry of Justice. Japanese individual account rules and results furnish the basis for determining corporate income tax obligations.27 Japanese financial reporting is aimed at investors (shareholders as well as creditors), blending traditions prevalent in the US/UK with those in Europe.28 Reports are intended to

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23 Wolfgang Bellweiser, *supra*, at 1241, notes:

> Besides protection for the equity and debt holders, financial reporting, especially when published, also ensures continued existence of companies, especially large limited companies, as a going concern. The public interest is involved in the fortunes of companies which are so large that their failure would have repercussions on whole sectors of industry and whole areas of the country. Since commercial accounting and tax accounting are interrelated, it is also the national interest that is being safeguarded, as well as that of the regions and municipalities which also benefit from the tax yield.

24 *See* Jacques Richard, France: Group Accounts, in 2 Dieter Ordelheide & KPMG, Transnational Accounting (2d ed. 2001), at 1137 ff. ("This way of presenting the profit and loss statement clashes with the dominant Anglo-Saxon tradition. In the Anglo-Saxon countries the financial accounting systems, owing to their economic orientation, are narrowly connected to management accounting, and give priority to the permanent inventory method: this implies that the concept of revenue is the sales and that expenses are classified by function (the cost of sales method).").

25 Jacques Richard, *supra*, at 1137 ff. (distinguishing asset conception between economic claims of right and patrimonial interests in tangible property only and concluding that (1) "Due to the weak development of the stock markets, the French financial accounting has been marked by the patrimonial concept" and (2) recent stock market development "has driven French accounting authorities to allow for more economic rules").

26Masatoshi Kuroda, Japan Group Accounts (in 2 Dieter Ordelheide & KPMG, Transnational Accounting (2d ed. 2001), at 1819 & 1825.

27 Kuroda, Japan Group Accounts, at 1826.

28 Kuroda, Japan Group Accounts, at 1826.

discharge managerial duties to shareholders and "coordinate the conflicting interests between shareholders and creditors."29

The hybrid character of Japanese accounting does not exactly put it between the UK/US and Franco-German. It sets Japan apart. It is no easier for Japanese than for French or German accountants to meet the challenge of the US/UK true and fair view. The countries share law-based and process-driven accounting systems rather than profession-based or substance-driven.

II. The Semiotic Challenge

US GAAP and British accounting have long adopted similar versions of the ultimate goal of financial reporting. In the US, GAAP seeks to report business condition and results according to a "fair presentation" (or "fairly presents"); in Britain, the goal is producing financial statements giving a "true and fair view" of business condition and results. These concepts, which differ subtly between the US and the UK, were utterly alien to non-Dutch Europe until the "true and fair" view was sanctioned by the Fourth Directive in 1978, driven by the UK's recent admission to the European Union. This was and remains a controversial provision.

The term is not defined by law in the US, the UK, or any country in Europe.30 This reticence reflects a common law sensibility in leaving to professional judgment the ultimate application of general rules to specific situations.31 The operational function of the standard entails that compliance with applicable accounting principles will presumptively but not invariably meet the standard. When they don't departures are necessary and they override literal compliance. The traditional continental European approach exemplifies the traditional civil law system, laying down detailed rules in codes intended to mitigate the play of judgment. Compliance with those laws is both necessary and sufficient to produce financial statements meeting the requisite standards—departures are deviant.

A semiotic challenge arises from the contingency of the true and fair view. Its meaning varies according to the ultimate purpose and attestation of the accounts: what they are intended to depict. In the US and UK achieving the view may mean tracking revenues and expenses using the accrual system and historical cost accounting conventions that result in reports mirroring external business activity—lumpy or smooth. It may then call for adjustments when applying those conventions to particular events fog the mirror. In Germany achieving the view may mean conducting the same sort of tracking but also conducting an allocation of the profits using hidden reserves according to internal corporate priorities among claimants. In France, state fiscal policies also drive outcomes. In both Germany and France, the true and fair view may be achieved by being

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29 Kuroda, Japan Group Accounts, at 1826.

30 *See* United Kingdom: Individual Accounts, in 3 Dieter Ordelheide & KPMG, Transnational Accounting (2d ed. 2001), at 2620.

31 Some debate whether US GAAP are better characterized as general principles or specific rules. This debate has no bearing on the methodology being described. Moreover, the debate is more of a distraction than a useful line of inquiry. SOX emphasizes the distraction, directing the SEC to assess whether a rules or principles based accounting system is superior. *See generally* Fred Gill, Principles Versus Rules, 29 *N.C. J. Int'l L. & Comm. Reg*. xxxx (2003).

faithful to all applicable rules, including tax rules and in Germany's case reserve norms.

Despite the shared aspiration of the "true and fair" view among these countries, an identical series of hypothetical transactions for a single business produces different results when prepared in accordance with each country's principles that remain faithful to each country's guiding norms. The differences tend to reflect an intuitive link to ultimate corporate purposes: in a period of economic prosperity, profits are highest under US and UK systems, lowest among Germanic systems, and in between for France and Japan. In periods of economic setback, German profits are higher than those in the US/UK.

International differences explain only part of the semiotic divergence. Within given countries, interpretation of the true and fair mandate varies. The British "true and fair" view dates to the Companies Act of 1844. That Act, and a series of subsequent revisions, cast the standard as requiring a "full and fair" or "true and correct" view.32 These concepts originally expressed the link between a company's internal records and its external reporting.

All British Companies Acts since 1948, including those currently in effect, require a "true and fair" view. This still partly reflects the goal of fidelity between internal records and external reporting. But the linguistic change also reflects the impossibility of a view of the balance sheet and income statement that is "correct."33 There are a number of potentially correct reporting methods and the current standard calls for producing one of them.34

The word *fair* is intended to command that the reports fall within the range of fidelity to both the internal records and to economic reality. The word *true* is intended to negate its opposite—false.35 It is not truth in its essence that is being sought, but the absence of lies, frauds, fabrications and other falsehoods. Few Anglo-American accountants believe that these demands entail simply complying with applicable accounting principles. The demands call for overriding those rules when particular facts and circumstances indicate that such compliance would constitute falsehoods or be out of

32 *See* United Kingdom: Individual Accounts, in 3 Dieter Ordelheide & KPMG, Transnational Accounting (2d ed. 2001), at 2620 (citing the Companies Acts 1844, Companies Act 1856, and Railways Companies Act 1867).

33 *See The Accountant* (July 1, 1944), at 2 (cited in Blake, et al., supra, The Struggle Against Creative Accounting (in accounting "there is no standard of absolute truth").

34 *See* United Kingdom: Individual Accounts, in 3 Dieter Ordelheide & KPMG, Transnational Accounting (2d ed. 2001), at 2620 ("The law does not require that 'the' true and fair view be shown but that 'a' true and fair view be shown.").

35 Alternative definitions view true as complying with the letter of rules and fair as complying with the spirit of rules. T.K. Cowan, Are Truth and Fairness Generally Acceptable?, *Accounting Review* (Oct. 1965), at 188-194 (cited in Blake, et al., supra, The Struggle Against Creative Accounting (ssrn.com 2002). The authors recall an old joke to illustrate the point. A ship captain believes his first mate may be imbibing excessively so makes a note in the ship's log that "the first mate was drunk today." The insulted mate returns the volley by entering in the next day's log that "the captain was sober today." Both statements may be true, but the inference of the second may not be fair.

the range of fidelity to the economic records and realities.36

Economic realities are measured by the instruments of accounting but the common law mind-set doubts its ability to craft *ex ante* rules universally applicable to address them faithfully.37 Accounting rules are tools, not truths; judgment is necessary to determine that their application in particular settings produces faithful measures of economic reality.

Accounting figures produced by rules are not inevitably the truth or inevitably a faithful representation of reality. They must be tested as such and when they cannot be verified as such must be departed from. One important consequence of this stance is that identical economic transactions conducted by different companies within the same country or in different countries may require different reporting.38

US law generally rejects that compliance with GAAP satisfies the fairly presents standard, at least with respect to an accountant's exposure to liability for failing to meet it. The American classic is Judge Henry Friendly's decision in *United States v. Simon.* It affirmed a trial court's refusal to give a defendant-accountant's proposed jury instruction that he could be found guilty of accounting fraud only if, under GAAP, the financial statements as a whole did not fairly present the company's financial condition (and then only if the departure from GAAP involved willful disregard and the accountant knew the financials were false and held an intent to deceive).39

Rejecting this proposed instruction, Judge Friendly instead defined the issue as whether the financial statements, taken as a whole, fairly present the company's financial condition and results. If they do not, then the issue is whether the accountant acted in good faith. Proving compliance with GAAP evidences good faith, but is not

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36 The Dutch statute captures the ultimate goal of the true and fair view succinctly:

> The financial statements shall in accordance with generally accepted accounting principles furnish such information as to enable a responsible opinion to be formed regarding the financial position and the profit and loss and, to the extent that the nature of financial statements permits, regarding the solvency and liquidity of the corporate body.

See David Alexander & Simon Archer, eds., Miller European Accounting Guide (3d ed. 1998), at 706 (quoting *Raad voor de Jaarverslaggering* (the Council for Annual Reporting, known as the RJ), § 362(1).

37 The common law sensibility assumes particular significance when applied to matters of accounting, where business environments evolve, technological innovation outpaces accounting tools, and the available principles of accounting fail to capture all economic particulars that may be relevant. *See* David Alexander & Simon Archer, eds., Miller European Accounting Guide (3d ed. 1998), at 1143 (it is "impossible to prescribe exactly what matters will be significant to readers from one year to the next. Hence, it is not possible to lay down exactly what will be necessary to convey a true and fair view.").

38 United Kingdom: Individual Accounts, at 2621 ("a term such as 'true and fair view' could end up meaning many more things than the various things it represents to different groups of the same or different societies.").

39 *United States v. Simon*, 425 F.2d 796, 805-06 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970); *see also SEC v. Seaboard Corp*., 677 F.2d 1301 (9th Cir. 1982). *But see SEC v. Arthur Young & Co*., 590 F.2d 785 (9th Cir. 1979).

conclusive.40 Relevant factors include the authoritative quality of the sources relied on in forming the judgment about what GAAP required.41 This perspective reflects that US GAAP are rooted in numerous sources, not articulated in a single code.42

The SEC certification requirements implementing SOX restate the US conception of "fairly presents" and its relationship to compliance with GAAP.43 The regulations require certification that "the overall financial disclosure fairly presents, in all material respects, the company's financial condition, results of operations and cash flows."44 The SEC clarifies that the certification is not limited to an attestation that the financial statements accord with GAAP, emphasizing instead the broader requirement of "overall material accuracy and completeness."45

In reaching this interpretation of Congressional intent and restatement of the US norm, the SEC cites Judge Friendly's classic opinion in *United States v. Simon*, cautioning that "Presenting financial information in conformity with generally accepted accounting principles may not necessarily satisfy obligations under the antifraud provisions of the federal securities laws."46 Thus the SEC takes the position that a "fair presentation" is not about results alone but also about:

> the selection of appropriate accounting policies, proper application of appropriate accounting policies, disclosure of financial information that is informative and reasonably reflects the underlying transactions and events

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40 *United States v. Simon*, at 805-06.

41 *See also* Theodore Sonde, The Responsibility of Professionals Under the Federal Securities Law—Some Observations, 68 *Nw. U. L. Rev*. 1, 4 (1973) ("[c]ompliance with generally accepted accounting principles is not necessarily sufficient for an accountant to discharge his public obligation. Fair presentation is the touchstone for determining the adequacy of disclosure in financial statements. While adherence to generally accepted accounting principles is a tool to help achieve that end, it is not necessarily a guarantee of fairness.")

42 *See* Shalala *v. Guernsey Mem. Hosp*., 514 U.S. 87, 101 (1995) (Kennedy, J.) (noting that for many accounting issues as many as 19 separate sources of authority could furnish guidance and these may be conflicting).

43 The SEC and SOX are criticized for failing to specify the circumstances under which departures from GAAP are warranted or required. *See* Christian J. Mixter, *United States v. Simon* and the New Certification Requirements, 76 *St. John's L. Rev*. 699 (2002).

44 Securities and Exchange Commission, Certification of Disclosure in Companies' Quarterly and Annual Reports, Release No. 33-8124 (Aug. 28, 2002). The reference to cash flows is also notable. It is not contained in SOX, but the SEC added it by regulation, taking the position that this is "consistent with Congressional intent to include both income or loss and cash flows within the concept of "fair presentation" of an issuer's results of operations." *Id*. *See infra* Part IV.

45 *Id*. ("We believe that Congress intended this statement to provide assurances that the financial information disclosed in a report, viewed in its entirety, meets a standard of overall material accuracy and completeness that is broader than financial reporting requirements under generally accepted accounting principles.")

46 *Id*., at n.55 (also citing *In re Caterpillar, Inc*., Release No. 34-30532 (Mar. 31, 1992); *Edison Schools, Inc*., Release No. 34-45925 (May 14, 2002)).

> and the inclusion of any additional disclosure necessary to provide investors with a materially accurate and complete picture of an issuer's financial condition, results of operations and cash flows.47

The SEC opines that this view is consistent with international standards, citing IAS 1's reference to elements to be considered in a GAAP framework to determine whether financial statements "fairly present" condition and results. These factors include "whether the disclosure is informative and reasonably reflects the underlying transactions and events."48

Even kindred countries—such as the US and the UK—can diverge in the degree of confidence they show in presumptively meeting the "true and fair" or "fairly presents" requirement simply by complying with relevant accounting principles. The practice norm in the US is that compliance is both necessary and sufficient. This is so despite an SEC rule expressly permitting departures when necessary49 and a body of case law led by Judge Friendly's opinion in *United States v. Simon* emphasizing that compliance with GAAP is not a defense to an action for fraud.50

The practice norm in the UK is to recognize the need for overrides and a "preference for a dynamic interpretation of the accounting provisions," despite a legal and theoretical presumption that departures should not be made.51 In fact, in 1981 the UK amended the Companies Act to expressly provide for a required override—affirmative departures from otherwise applicable standards.52 A chairman of the Accounting Standards Board emphasized the virtue of the system as progressive, in hastening the advancement of accounting practice to keep pace with business evolution.53 On the other hand, as in the US, compliance does furnish a strong indication of achieving the true and fair view.54

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47 *Id*. at n.56.

48 *Id*. The standards do appear consistent, though it is equally obvious that the SEC's elaboration is broader than the IAS elaboration. It includes as factors the selection and application of accounting standards. Does the SEC explanation comfort or confound a non-accountant CEO in making this certification? In general, strict compliance with GAAP may require greater accounting expertise than the broader notion of an "overall accurate and complete picture." But this may be more accurate for the non-accountant CEO of a US (or UK) SEC registrant than for a CEO of a non-US (or UK) registrant. For them, characterization of the picture as "accurate and complete" continues to beg the question.

49 SEC Rule 203.

50 *E.g., SEC v. Seaboard Corp*., 677 F.2d 1301 (9th Cir. 1982). *But see SEC v. Arthur Young & Co*., 590 F.2d 785 (9th Cir. 1979).

51 *See* United Kingdom: Individual Accounts, in 3 Dieter Ordelheide & KPMG, Transnational Accounting (2d ed. 2001), at 2622-23; David Alexander & Simon Archer, eds., Miller European Accounting Guide (3d ed. 1998), at 7 & 1142.

52 *See* Blake, et al., supra, at 14.

53 D. Tweedie, *Imagen Fiel* v. The Rule Book: Which Is the Answer to Creative Accounting?, Pac. Acct. Rev. (Dec. 1988), at 1-21 (cited in Blake, et al., supra).

54 *See* Blake, et al., supra, at 14 (citing Joint Opinions of Counsel and opining that "adherence to standards may in most cases result in a true and fair view").

Countries attempting to follow the UK standard have devoted substantial efforts to offering precise definitions of the phrase true and fair view, but remain befuddled in those efforts.55 In Australia—which has long followed UK accounting practice—1983 amendments to the Companies Act endorsed by the Australian Accounting Review Board adopted the override principle, requiring departure from rules if application failed to yield a true and fair view.56 Concern subsequently arose that directors were using this override provision not so much to meet the spirit of the true and fair view as to justify departures from undesired rules.57 As a result, in 1991 the law was amended again to effectively eliminate the override option and replace it with a requirement to add information necessary to give a true and fair view.58 This election was seen as the only sensible course, given decades of futile effort among Australian accountants and regulators to adequately define the concept of true and fair.59

European countries enacting the mandates of the Fourth Directive adopted a range of responses from insisting on strict compliance with rules to permitting the override in defined contexts.60 The varying strategic responses were possible given the architecture of the Fourth Directive. It articulates three related components. Mandate 1 is the true-and-fair view itself: "the annual accounts shall give a true and fair view of the company's assets, liabilities, financial position and profit or loss." Mandate 2 is for supplemental disclosure: "Where application of the provisions of this Directive would not be sufficient to give a true and fair view within the meaning of [the foregoing provision], additional information must be given." Mandate 3 is an override principle: if applying provisions of the Directive is incompatible with Mandate 1, then those provisions "must be departed from" in favor of producing a true and fair view with such departures disclosed in the notes.

Despite the Fourth Directive's attempt at clarity, the resulting menu facilitates a

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55 Countries include Australia, Malaysia, New Zealand, and Singapore *See* Blake et al. supra, The Struggle Against Creative Accounting, at 11.

56 A. Rahman, The Australian Accounting Standards Review Board: The Establishment of Its Participating Review Process (1992) (cited in Blake, *et al., supra*).

57 C. Deegan, P. Kent & C.J. Lin, The *Imagen Fiel*: A Study of Australian Auditors' Application of the Concept, 4 *Australian Acct. Rev*. 2 (1994) (cited in Blake, et al., supra, at 17-18).

58 Blake, et al., *supra*, at 17 (citing M.A. Sadhan & I.A. Langfield-Smith, A Qualitative Standard for General Purpose and Financial Reports: A Review, Australian Accounting Research Foundation (1993), at 13 (quoting statute: "Where compliance would not the directors' opinion give a 'true and fair' view the directors are required to add such information as will give a 'true and fair view'").

59 *See* Blake, et al., *supra*, at 18-19 (summarizing various Australian efforts to define true and fair, including one commentator concluding that the concept while "making a pleasant appeal to the eye and ear" turns out to be "a snare and a delusion to the uninformed") (quoting Ryan (1974), at 8).

60 European Directives agreed by the Union oblige member states to enact compliant national legislation. Directives are issued in each European language and legislation is enacted in local languages. Language in translation does not always produce semantic identity, especially of specialized technical terminology such as the true and fair view.

wide range of strategic interpretations. Taken literally, Mandate 1's call for a true and fair view seems paramount. To a student of US/UK accounting (or Dutch accounting), Mandate 1 in itself carries particular implications in context.61 This take holds that the true and fair view is intended to eliminate the use of hidden reserves and to distinguish between financial reporting and tax reporting.62 But this is by no means clear to a student of German, French or Japanese accounting where compliance with law—including use of hidden reserves in Germany and kindred states and of obedience to related tax accounting laws—creates a presumption of complying with the true and fair view requirement. Mandate 1 is met by such compliance. Thus Sweden has adopted the standard of preparing accounts in accordance with accounting principles intended to produce a true and fair view, but has refrained from applying the true and fair view override (of Mandate 3).63

The presence of Mandates 2 and 3 can be seen either to challenge or to reinforce the legitimacy of this stance. The presence of Mandates 2 and 3 challenges the stance to the extent the Mandates would otherwise be superfluous, dead letters. They must mean something and everyone knows they were added at the behest of the UK where the concept of true and fair originated. But meaning can be given to them by observing the theoretical possibility that adhering to bookkeeping rules may not produce a true and fair defined in terms of those national rules either, though there may be far fewer circumstances when this is the case compared to those arising when applying US or UK accounting.

The case for a weaker adherence to Mandate 1 is stronger yet when you consider that Mandates 2 and 3 can be read to provide alternative responses when Mandate 1 would otherwise be unmet. Thus a preparer can provide supplemental disclosure under Mandate 2 *or* exercise the override directive of Mandate 3. The Australian history makes the point, since it once embraced the override principle reflected in Mandate 3 and later abolished it in favor of the supplemental disclosure approach reflected in Mandate 2. The menu-effect in Europe is real: Finland takes the true and fair view to require supplementary information in the footnotes when the standard would otherwise not be met,64 while Denmark has adopted the override principle in law but invocations of it are

61 David Alexander & Simon Archer, eds., Miller European Accounting Guide (3d ed. 1998), at 700, 720 (noting that Dutch accounting is of an Anglo-Saxon nature that elevates substance over form and adopts the true and fair, written in Dutch as *een getrouw beeld*). The true and fair view override is established as part of the law and carries the duty to provide information in addition to what is specifically required by law. *Id*. at 706.

62 David Alexander & Simon Archer, eds., Miller European Accounting Guide (3d ed. 1998), at 20.

63 David Alexander & Simon Archer, eds., Miller European Accounting Guide (3d ed. 1998), at 1111 (noting that strict Swedish interpretations "deviate from corresponding interpretations in other European countries" with interpretations and applications of the European Directives that "come out differently").

64 David Alexander & Simon Archer, eds., Miller European Accounting Guide (3d ed. 1998), at 256. Adherence to 'good accounting practice" (*oikeat ja rittävät tiedot*) remains the normal professional instinct of the Finnish-trained accountant. Notably, the

rare and its deeply-rooted embrace of the prudence principle endures despite acknowledged conflict between the two.65

Another factor strengthening this stance is precisely that the true-and-fair view's home state of Britain leaves the concept highly contingent and potentially indeterminate (as does its chief follower, the US). The impermeability of this semiotic challenge becomes clear when you consider that Italy translates the true and fair standard as "true and correct" (*rappresentare in modo veritiero e corretto*)66—the original 19th century UK position—which is then equated with Italian civil law dating to 1882 requiring "straightforwardness and truth" (*evidenza a verita*).67

The Italian position reveals a fundamental issue of translation. European Directives are implemented according to the language of member states. While the Fourth Directive seems to compel using the phrase true and fair view, the phrase nevertheless must first be translated linguistically.68 Imprecision is the natural price of translation. A clear example of some sacrifice in precision is that many countries translated the true and fair view into a single word, muting the subtle complimentarity of the true and fair pairing painstakingly crafted in British accounting history. Thus Greece uses "real" while France, Belgium, the Netherlands, Spain and Luxembourg use "faithful."69

It is entirely legitimate, therefore, for those trained to understand financial reporting as a partial product of tax law and with a goal towards protecting creditors through prudent reserves, to conclude that financial statements give a true and fair view when these principles are obeyed. The mind set is hard to change, just as the mind set of a US or UK accountant accustomed to exercising judgment is hard to change to a greater process orientation.70

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concept of "good accounting practice," like the concept of the true and fair view, has no exact definition in Finland. *Id.*

65 David Alexander & Simon Archer, eds., Miller European Accounting Guide (3d ed. 1998), at 207. Danish-trained accountants focus on the process, not the "holistic concept" of the true and fair "relating to the desired attributes of the end-product as a whole, seen from the users' point of view." *Id*.

66 In earlier legislation, Italy translated the terms as the French do, as faithful picture (*quadro fedele*). David Alexander & Simon Archer, eds., Miller European Accounting Guide (3d ed. 1998), at 581.

67 David Alexander & Simon Archer, eds., Miller European Accounting Guide (3d ed. 1998), at 583 (discussing Civil Code Article 2217, section 2). Italian accounting also requires presentation with clarity and precision (*chiarezza e precisione*). *Id.* (citing Civil Code, Article 2423, section 2).

68 *See* Navarro (1996) (cited in Oriol Amot, supra).

69 *See* C. W. Nobes, The *Imagen Fiel* Requirement: Impact On and Of the Fourth Directive, 24 *Accounting Business Research* 35 (1993). Similar translation differences exist across Europe, such as right-looking and according to facts (Denmark) and true and appropriate (Portugal). *Id*.

70 David Alexander & Simon Archer, eds., Miller European Accounting Guide (3d ed. 1998), at 20-21. For American readers, imagine if US tax laws directed filers to follow rules defining their annual income, deductions, exclusions, and credits to compute taxable

Any legal or systemic principle when translated faces this challenge. It multiplies in the context of accounting because the exercise itself involves semiotic representation using principally numbers—supplemented by words—to depict complex economic reality. In the end, representational faithfulness is in the eye of the accountant, despite international agreement on ultimate goals, use of similar terminology, and (for Europe and the UK at least), a common legal text. Some global responses to the true and fair mandate have taken this legitimacy seriously, while others have struggled mightily to achieve legitimacy by other means. A closer look at these global responses follows.

III. Select Global Responses

International accounting standard-setters have toiled for decades on a harmonization scheme, work that has gained practical and accelerated momentum amid realization of globalization's force in the latter 1990s and potentially greater urgency in the wake of SOX. All major countries joined the process of iterating between helping to draw international standards, adapting them in some manner into domestic standards and law, and then seeking to re-export them back into the international standard setting process. The iterative import/export process is most profound concerning the true and fair view standard, with nations offering alternative approaches to meet the semiotic challenge it poses. A capsule review of how selected major countries faced the challenge shows the enduring obstacles to harmonization that using the concept entails.

A. Hermeneutics

The chief pressure point on German accounting law is to transform traditional German accounting's prudence principle into information useful for capital market participants. As in other major countries, the vehicle is development of accounting principles for corporate groups (known in the US as consolidation accounting and in Europe and the rest of the world as group accounts).71

As law, German group accounting is authorized by the legislature, and developed by GASB under the supervision of the Ministry of Justice.72 Legislation now authorizes group accounting using IASC or US standards until GASB finalizes German group accounting. This authorization led large numbers of German corporations to use those standards (at least 15% of German listed companies).73 Conditions for taking the

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income and tax and then invited them to make an ultimate determination of whether the results present a fair view of the filer's actual economic performance for the year.

71 Group accounting is the term used around most of the world to refer to what US accountants call consolidation (the EU's Fourth Directive calls it this too but the term group remains the general reference). US GAAP concerning consolidation dates to the 1950s, with a formal pronouncement set out in Accounting Research Bulletin No. 51 in 1959. The basic principles have been well-settled for a long time and most technical aspects are now elaborated in accounting textbooks rather than formal promulgations. Nobert Fischer, *et al*., USA Group Accounts, in 3 Dieter Ordelheide & KPMG, Transnational Accounting (2d ed. 2001), at 2993.

72 Ordelheide, German Group Accounting, *supra*, at 1362. New German group accounting standards are to be adopted by the newly-established German Accounting Standards Board (GASB—*Deutscher Standardisierungsrat*, DSR), which will include standards for cash flow statements and segment reporting.

73 *Id*. at 1369 (as of August 1999, 15.4% of German listed companies (117 in total) so

international option include that reports accord with EU Directives, are at least as informational as German Commercial Code requirements, and disclose how principles vary between group and German accounting.74

Despite these efforts, critics cite two features of German group accounting that impair the quality of financial reporting necessary for capital market participants: profit determinations are tax-driven and products of hidden reserve practices. Defenders argue that while individual accounts remain tax-driven, legislative authorization to prepare group accounts permits preparation unconstrained by the tax-driven rules and free of certain reserve norms. German multinationals in practice seem to opt for this flexibility, but German group accounting principles at present do not require them to do so.75

As a matter of law, moreover, German accounting continues to adhere to its "General Norm," which calls for compliance with the principles of proper bookkeeping. Law also requires adherence to the true and fair view, but even within group accounting this remains a subordinate principle in application.76 It is a nominal embrace of Mandate 1 of the Fourth Directive. When such adherence would fail to produce a true and fair view, footnotes are to disclose what deviations would be necessary to produce a true and fair view. This is an embrace of Mandate 2 of the Fourth Directive. It reflects the civil law sensibility, in contrast to the common law sensibility which would invoke Mandate 3's override approach and apply different principles.

Whether the German approach alters or waters down the meaning of true and fair view or simply locates its achievement in a different place is a source of endless debate. The critical view declares that Germany has not embraced the true and fair requirement of the Fourth Directive (or the Seventh Directive, which extends itself to group accounting). This criticism assumes that the true and fair view relates to the numerical presentation on the balance sheet and income statement. The notes supplement these

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opted (73 and 9.6% IAS and 44 and 5.8% US GAAP)).

74 German individual accounts are still critical for each entity and its determination of profit available for distribution and for taxes, as well as to investors as to their position and risks in that individual entity. Group accounting puts it all together to form a whole.

75 Ordelheide, German Group Accounting, *supra*, at 1370-71 reports:

> it is at least possible to use the options available in German law to prepare group accounts that put more emphasis on the information function. In particular, quoted companies, above all the large international groups, have made efforts in this direction. So it is no surprise that, contrary to the notion that the accounting data of German corporations are essentially meaningless, it has been found that these data are significantly associated with stock price levels and returns.

76 This remains the case despite efforts of some leading accounting and law scholars and courts, including the European Court of Justice. 1996 European Court Reports I-3113, Case 234/94, *Tomberger v. Gebrueder von der Wettern*. *See* Bernhard Grossfeld, Comparative Corporate Governance: Generally Accepted Accounting Principles v. International Accounting Standards?, 29 *N.C. J. Int'l L. & Comm. Reg.* (2003) (noting his role in adding the true and fair view to the German Commercial Code and noting the European Court's holding that the "'European principle of truth' was the overriding yardstick for every detail wherever located in the financial statements).

central features of the statements. The German hermeneutic response characterizes the numerical presentations and the notes as forming a unity constituting integral elements of the hermeneutic circle users create in reading financial statements.

The stance is justified as a matter of positive law by virtue of the existence of Mandate 2's disclosure provision as a seeming alternative to Mandate 3's override provision.77 It has been rejected as a matter of positive of law by the European Court of Justice.78

The justification as a matter of hermeneutics is also difficult to sustain. Hermeneutics is the centerpiece of a major innovation in civil law methodology, rooted in the work of Gadamer and Heidegger.79 In accounting, it refers to the process a user pursues in comprehending a set of financial statements.

A financial statement user starts with a pre-understanding of the rules governing its creation and approaches the statement with a purposive expectation of its meaning given those rules. So armed, the user's reading of the statement continuously requires adjustment to that pre-understanding as the information reveals new meanings. The relation between a user's pre-understanding and the incremental unfolding of new meaning through engagement with the statement and its component parts in this process forms a hermeneutic circle. The serial revision of one's pre-understanding through the process of reformation by absorption of the statement's parts constitutes comprehension. Thus the elements of the statement—the numerical presentation as well as narrative footnote disclosure—collectively sustain the creation and realization of the hermeneutic circle.

According to this hermeneutic philosophy, achieving a true and fair view is possible either in the numerical presentation or in the notes. As a practical matter, moreover, this enables meeting both objectives, a Europe and capital-market driven true and fair view and a German and legislative driven mandate of the General Norm to comply with bookkeeping rules.80 Indeed, this is the only way to meet both objectives.81

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77 Note that the challenge facing Germany differs from that facing Australia. Traditional accounting differs between these countries due to their respective civil versus common law heritages and bank versus shareholder corporate finance traditions.

78 *See supra* note xxx (citing *Tomberger v. Gebrueder von der Wettern).*

79 . *See* Hans-Georg Gadamer, Truth and Method (Garrett Barden & John Cumming eds. & trans., The Seabury Press 1975) (2nd ed. 1965); Martin Heidegger, Being and Time 191-203 (John Macquarrie & Edward Robinson trans., Harper & Row 1962) (1927).

80 Ordelheide, German Group Accounting, *supra* at 1373. Apart from this debate in theory and law, however, in practice German corporate groups are leaning towards presenting the true and fair in the numerical data, subordinating the General Norm, and implicitly meeting its requirements by footnote disclosure.

81 In the parallel domain of financial valuation, modern finance theory bears a greater resemblance to European traditions and fundamental valuation analysis kinship with Anglo-American traditions. MFT atomizes companies in markets and uses the pricing volatilities of traded securities to ascertain key valuation components, critically the discount rate or cost of capital. There is a tendency to believe in the objectivity of the

The difficulty with the hermeneutic circle as applied to financial statements is that users of financial statements are unlike judges engaging legal texts or theorists developing literary interpretations. Financial statement users seek hard data concerning liquidity and value. They are far less likely to formally engage in such a process of complete comprehension compared to judges or literary users. Even at its best, financial statement analysis entails an exercise of isolating particular parts of the statements and relating these to each other. This risks leaving the hermeneutic circle unclosed.

Among standard analytic tools employed to read financial statements, moreover, are a series of financial ratios, such as the current ratio, the debt-to-equity ratio, the inventory turnover ratio, and the cash-interest-coverage-ratio. All these exercises rely on the numerical information contained on the face of the statement. Supplementing these by footnote disclosure is possible but does not guarantee a hermeneutic circle.

Even among jurisprudential and literary invocations of the hermeneutic circle, a judge's or reader's preconceptions cannot be eliminated.82 Biases persist. The magnitude of bias risk is greater in financial statement analysis. Psychology plays a formidable role among users of financial statements.83 For example, the saliency bias exposes users to the risk of overemphasizing numerical figures, particularly bottom line figures, in subordination to elaborate textual explanations. Such cognitive biases disrupt forming complete hermeneutic circles. In practical terms, therefore, the hermeneutic circle's policy attractiveness is limited.

As a matter of logic, moreover, if the notes are intended to clarify the numbers, then an accounting system needs principles for the notes that are no more opaque. But if it is possible to establish such transparent principles for the notes, then it must be at least as possible to establish them for the numbers. And if this clarification can be done in the notes, then it seems superior to do it in the numbers, given their relative saliency. The comparative need for fidelity is in the numbers, not the notes. This means promoting uniformity of assumptions made in preparing the numbers, not trying to develop clarifying assumptions to guide uniformity in the meaning and reliability of the notes. Accordingly, the hermeneutic circle does not meet the semiotic challenge.

B. Anarchy

The Anglo-American norm is translated in France as the *image fidèle*, which in turn traces to a preexisting French accounting concept undoubtedly bearing a different signification, *regularitè et sincerité*.84 The French *image fidèle,* added by law in 1982 to meet European Directives, also calls essentially for complying with accounting rules. It is famously flexible, yielding the same image of fidelity when accounting is performed using different philosophies, so long as rules are followed. The varying philosophies

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results, a step insulated from professional judgment. Traditional fundamental valuation analysis applies a variety of rigorous tools and adheres to a body of principles, but explicitly recognizes the importance of judgment in testing the results.

82 *See* Baudenbacher, *supra*, at 348 (citing Gadamer, *supra*, at 238).

83 *E.g.*, Lawrence A. Cunningham, Behavioral Finance and Investor Governance, 59 *Wash. & Lee L. Rev*. 767, 774-778 (identifying select psychological factors influencing investor decision-making and citing additional sources).

84 *See* Blake, et al., supra (citing A. Burlaud, *Commentaires sur l'article de David Alexander "A European Imagen Fiel*?, *Euro. Acct. Rev.* (May 1993), at 95-98).

yield various uses—not quite meanings—for the true and fair view. These have developed through the evolution of French group accounting, which is undergoing dramatic change.

In mid-1998 under pressure from France-based multinationals, the French General Assembly authorized these companies to adopt either IASC accounting standards or US accounting standards, subject to various conditions. In late 1998, the legislature formally adopted many IASC standards as part of French group accounting law. The scale of requisite conversion and the various conditions attached to shifting from French accounting to either IASC or US standards rendered these legislative efforts more an aspiration for liberalization, not its realization.85

French accounting traditionally was a highly regulated and uniform system but business pressures of globalization and these legal developments change the picture, at least for multinational group accounts. The result is growing divergence within French accounting between individual and group accounting. Divergence also arises within group accounting, as differences grow between the literal requirements of group accounting and the group accounting produced in practice. Further fragmentation arises between group accounting practiced by multinationals which approaches international standards and group accounting practiced by domestic companies which tends to adhere to traditional French accounting. All strands of divergence are further complicated by the fact that all French legal change "is deeply rooted in a nexus of economic, political and social events."86 Reactions to this anarchic condition in French accounting are diverse, varying with social groups. Leading commentators wonder whether French group accounting law is "heading towards regression, isolation or generalization."87

The divergence by French group accounting from its traditional individual accounting reflect how constrained French multinationals found themselves in contending with traditional French accounting.88 French industrial pressure to move toward more liberal group accounting began in 1966 when Rhone-Poulenc, Saint-Gobain

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85 One condition to adopting the alternatives is that the French CRC must adopt the law as regulation, which it showed reluctance to do. Among its concerns with respect to US standards are the opposition by "many French specialists" to "the idea of using the standards of a foreign country." Jacques Richard, *supra*, at 1136. The other two conditions are that the standards must (1) be translated into French (done or doable for IASC, far more complicated and yet to be done for US GAAP) and (2) harmonize with EU standards (set forth in the Seventh and Fourth Directives), which is problematic in several ways. So far, it is impossible to comply with both EU and IASC standards. The solution of a company picking and choosing from one set or the other as a way to develop compliance with both is problematic in its own right, and also may not be permitted under IASC, EU or French standards. Despite the efforts and movement, "influential members" of France's CNC and CRC "began to lower the chances of the IASC to achieve its task of worldwide accounting harmonization." *Id.*

86 Jacques Richard, *supra*, at 1137.

87 Jacques Richard, *supra*, at 1136.

88 Jacques Richard, *supra*, at 1139 ("if the French accounting plan provided for individual financial accounts had been applied to group accounts, the French multinational would have found themselves in a very restrictive corset indeed.").

and Total adopted US standards, leading France to develop formal group accounting rules two years later.89 But development was unsatisfactory, leading the COB (the French Bourse Commission) to permit using IASC or Anglo-Saxon standards, including the US. By this time, French group accounting for its 400 multinationals was in a state of "dreadful anarchy," using a blend of French, US, IASC, EU and general international standards.90

Europe's Seventh Directive furnished an occasion to harmonize French group accounting from its disorganized state.91 The result was a French legislative corpus on group accounts promulgated in 1985. Yet French group accounting still lacks a "homogenous, economic-oriented legislation."92 In fact, instead of harmonization the legislation effectively codified two sets of rules, one for national groups and one for international groups. Differences are acute in the method of reporting expenses, using the traditional French total costs method for national groups and the cost of sales method for international groups. This "recourse to different methods" results "from the desire to permit national groups to go on applying traditional French practices while allowing multinationals to choose more international methods."93 This recourse is in default of global standards, a legislative punt to the demands of global stock markets to enable French multinationals to compete in globalization.94

Reactions to the evolution in French accounting are mixed. Applauding it are representatives of the big multinational companies and of their French employees. Other experts "regret the trend of French accounting towards Anglo-Saxon models of financial statements"95 wishing instead for evolution along lines with individual accounts. Another group is less bothered by the trend towards more economic principles of accounting but lament that French individual accounts weren't being modified in the same direction. One result of what has happened is individual accounts are still geared to state fiscal policies and taxation, whereas the group accounts sever the tax-accounting link and move to capital market type accounting including adherence to a conception of the true and fair view more nearly in line with Anglo-American traditions.

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89 Jacques Richard, at 1139.

90 Jacques Richard, *supra*, at 1140 (of the largest 15 French multinationals, 6 used US (FASB/ASB); 4 IASC; 4 EU; and 1 an international mélange).

91 Europe's Seventh Directive calls for drawing up consolidated accounts based on (a) majority voting rights; (b) majority directorial power or (c) the exercise of a "dominant influence."

92 Jacques Richard, *supra*, at 1143. In fact, French multinational group accounting need not comply with traditional French accounting law. France relies on individual accounting "as playing the long-established role in relation to regulation of dividends, taxation, and disclosure, while consolidated accounts are 'just' supplementary information of a more economic nature." David Alexander & Simon Archer, eds., Miller European Accounting Guide (3d ed. 1998), at 298.

93 Jacques Richard, *supra*, at 1144.

94 Jacques Richard, *supra*, at 1144 (absent global accounting standards, the French legislator "has chosen to give French international groups great leeway in adapting to the peculiarities of the world's major stock markets.")

95 *Id.*

A surprising consequence is that French multinational group accounting is even more dedicated to the true and fair view and its override mechanism than Anglo-American is—a striking departure from traditional French accounting which is seen among the most rigid in the world.96 The risk is the one Australia faced during the period it authorized the override—managerial opportunism—which led Australia to seal the override route in favor of the supplemental disclosure route.

C. Struggle

A third strategy to respond to the semiotic challenge may simply be described as struggling. Spain is illustrative. Spain's Accounting Standards and Principles Commission announced in its Document No. 1 that the annual accounts must contain information to aid decision-making by users, including giving "a true and fair view of the economic and financial situation of the company."97 Evincing a piquant common law outlook for a civil law (Romanic) nation, official Spanish accounting law elaborates that the concept "is not fixed or delimited" but "tries to express the double notion of impartiality and objectivity."98 Mixing traditions, the standard holds that a true and fair view will result from "systematic and regular application of accounting principles [but recognizes that these] will not be applicable in particular transactions [when] incompatible with a true and fair view."99 Authority exists for both the override (Mandate 3) and the additional information approach (Mandate 2).

Spanish accounting scholars are careful to emphasize that lest the Spanish interpretation appear "diaphanous," the "existing confusion is in line with the disorientation at an international level."100 Spanish scholars agree that a definition of true and fair is elusive and offer to respond to the challenge using two alternative interpretive strategies, epitomized elsewhere: the legalist approach of systematic application of the rules or the economic approach of fidelity to economic reality and elevating substance over form.101

The latter, in turn, can be met either by invoking the "supplementary character" of Mandate 2 (adding disclosure) or the "priority character" of Mandate 3 (overrides) and the choice concerning these is itself a choice invoking professional accounting judgment.102 This leaves ample room in practice for a wide variety of responses, from civil law traditions of adhering to the legalistic approach as sufficient, to varying

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96 *See id.* ("Some might even claim that in the area of consolidation the flexibility of French legislation is even greater than the American; this is a rather astonishing situation when traditionally French accounting has been described in the international literature as a typical example of highly rigid accounting!").

97 Blake, et al., supra, at 19 (citing AECA, Accounting Standards and Principles Commission announced in its Document No. 1, at 14).

98 Blake, et al., supra, at 20 (citing *Plan General de Contabilidad* (Real Decree 1643/1990).

99 *Id*.

100 Blake, et al., supra, at 21.

101 Blake, et al., supra, 21.

102 Blake, et al., supra, at 22 (citing Pereda J. Tua, *Algunas precisions adicionales en torno al principio de imagen fiel, Tenica Contable* (Dec. 1985), at 442).

invocations of Mandates 2 or 3.103 The struggle continues.

IV. Cash to the Rescue

If harmonization of the true and fair has been among the least successful ambitions of global accounting, one of its chief successes is establishing the statement of cash flows. The cash flow statement—a relative newcomer even to US and UK accounting—transcends differences of accrual accounting in the US and UK and is a fruitful place to transcend cross-border differences.104 It is through cash flow statements that the world can have her cake (harmonized accounting) and each country can eat it too (her own accounting).

The true and fair view requirement relates traditionally to the balance sheet and the profit and loss statement.105 The fierce trouble it causes is due to differences in the determination of income and measurement of assets across the world (not to mention within countries). Yet all major countries now agree that cash flow statements are integral to a full set of general purpose financial statements and all substantially agree on how it should be prepared. There are areas of debate, but these are minor in comparison to disagreements relating to the balance sheet and income statement.106 And the cash flow statement constitutes, *ipso facto*, a true and fair view—without need for defining or debating that concept's meaning or how to achieve it.

The prospects for harmonization in the cash flow statement are therefore great, if not a *fait accompli*.107 It is thus ironic that it is the one place to which the true and fair view has not been fully applied.108 Even SOX's officer certification requirement does

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103 Blake, et al., supra,, at 22-23(citing sources).

104 Another major success is segment reporting—also relatively new in the history of accounting, in the US and the world. It helps users deconstruct numerical information otherwise entangled in financial reports that are the product of different accounting rules.

105 *E.g.*, UK Companies Act 1985, Sec. 226(2) ("The balance sheet shall give a true and fair view . . . ; and the profit and loss account shall give a true and fair view . . ."); s*ee also* Christian Leuz,The Development of Voluntary Cash Flow Statements in Germany and the Influence of International Reporting Standards (Dec. 1999) (available from ssrn.com), at 3 (noting that HGB 264(2) and 297(2) require the true and fair view but that "Based on the legal commentaries, it is generally accepted that this requirement does not apply to a cash flow statement."); *supra* note 36 (quoting Dutch statute).

106 As discussed below, areas of disagreement are pretty much limited to matters at the borders of defining cash equivalents, classification of cash-related activities (as operating, investing, and financing), and methods or presentation (direct or indirect).

107 A 1998 survey of the 125 countries that are members of IOSCO found that 82 countries had adopted IAS 7 concerning statements of cash flows. *See* Financial Times Survey Reveals Patchy Compliance with International Accounting Standards, *CPA Journal* (Mar. 1, 2000), at 13. Among those that had not were Australia and the UK, and both of these have cash flow statement requirements that do not vary radically from IAS 7.

108 *See* Christian Leuz, The Development of Voluntary Cash Flow Statements in Germany and the Influence of International Reporting Standards (Dec. 1999) (available from ssrn.com), at 3 (noting that while German law does not apply the true and fair view requirement to the cash flow statement it "is viewed as generally sufficient to provide a

not apply to the cash flow statement. In its implementing regulations, however, the SEC extends the certification requirement to include the cash flow statement.109 This is notable because of all the components of a set of general purpose financial statements prepared in accordance with any accounting system, the cash flow statement is least affected by discretionary matters that implicate interpretive questions concerning true and fair—it is true and fair by definition without regard to the definition! As notable, the proliferation of the cash flow statement was at least as much a product of market pressure as conscious harmonization efforts.110

A. Utility

Cash flow analysis and fair value accounting have assumed increasing importance in the past several decades as theory and practice increasingly focuses on cash generation as the ultimate result of productive activity, cash management as a measure of managerial prowess, and cash-based valuation techniques as a key tool in corporate decision-making.111 Cash flow statements enable users to assess cash flow generation and absorption. That enables users to compare the present value of probable future cash flows across different businesses.

For global harmonization quests, the cash flow statement promotes the comparability of reporting across varying accounting systems. The cash flow statement is unaffected by underlying accounting differences. Indeed, it consciously reverses any such differences out.112 The lingering cultural disagreement concerning the statement is pretty much confined to defining cash equivalents that are included in the flow, a relatively modest issue particularly compared to issues arising under traditional accounting principles across nations.113

The standard cash flow statement format distinguishes among three sorts of cash flow: operating, investing, and financing. All are useful to any business, but each adds

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true and fair view”).

109 *See* Securities and Exchange Commission, Certification of Disclosure in Companies' Quarterly and Annual Reports, Release No. 33-8124 (Aug. 28, 2002) (explaining extension as “consistent with Congressional intent to include both income or loss and cash flows within the concept of "fair presentation" of an issuer's results of operations.”).

110 *See* Christian Leuz, The Development of Voluntary Cash Flow Statements in Germany and the Influence of International Reporting Standards (Dec. 1999) (available from ssrn.com).

111 *See* Stanley Siegel, The Coming Revolution in Accounting: The Emergence of Fair Value as the Fundamental Principle of GAAP, 42 *Wayne L. Rev.* 1839 (1996).

112 *See* Bernhard Grossfeld, Global Valuation: Geography and Semiotics, 55 *S.M.U. L. Rev.* 197, 203-04 (2002):

> [I]t is globalization that makes cash flows more attractive than earnings as an international yardstick. Earnings are the result of many discretionary decisions that are tainted by different and often submerged cultural assumptions (consider depreciations or the setting up of hidden reserves). Cash flows can be measured objectively, as cash is cash in any money-oriented economy.

113 Jacques Richard, France, *supra* at 1206 (enduring issues tend to focus on the definition of cash equivalents).

differential value to information depending on a company's life-cycle stage. For example, investing and financing cash flows add particularly valuable information concerning start-up and rapidly-growing businesses (those with fewer assets) whereas operating cash flows add particularly valuable information concerning mature or declining companies (those with more assets). The statement as a whole thus offers significant value across a range of businesses.114

While most countries follow this three-part classification scheme, there is some variation. For example, the UK cash flow statement classifies activities into eight headings rather than three. On the other hand, the eight headings map reasonably well onto the more standard three-part approach.

The cash flow statement can be prepared using either the direct method or the indirect method.115 IAS and most countries permit the use of either.116 The US recognizes both, though it encourages using the direct method while most companies use the indirect method.117 The UK requires the indirect method and Australia requires the direct method.118 The disagreement is narrow, for the difference relates only to the portion of the cash flow statement relating to operating activities, not to investing or financing activities. Despite these differences, moreover, the direct and indirect methods are both seen as useful. Some evidence indicates that the direct method is more useful in that it has a superior relative ability to predict future operating cash flows.119

The cash flow statement has also proven to be a more reliable tool (focused on cash flows) than traditional accounting tools (focused on balance sheets and income statements) in predicting bankruptcy filings under Chapter 11 of the US Bankruptcy Code120 and insolvency generally.121 It can be a highly reliable gauge of business

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114 *See* Ervin L. Black, Life-Cycle Impacts on the Incremental Information Content of Earnings and Cash Flow Measures (available on ssrrn.com) (April 27, 1998).

115 *See* Norvald Monsen, Cameral Accounting and Cash Flow Reporting: Some Implications for Use of the Direct or Indirect Method, 10 *Euro. Acct. Rev.* (2001) (also arguing that the debate centers on commercial double-entry bookkeeping systems and that this debate can be informed by single-entry cameral accounting used by governmental organizations and that this information supports using the direct method).

116 *See* Palgrave: Germany: Group Accounting, *supra* at 1428; France, *supra,* at 1205; Japan, Group Accounting, *supra* at 1866; Netherlands, Individual Accounting, *supra* at 2003.

117 SFAS 95, para. 27

118 *Compare* Palgrave: United Kingdom Group Accounting, *supra with* Australian Group Accounting *supra* [confirm statement concerning Austrlia].

119 *See* Gopal V. Krishnan & James A. Largay, On the Usefulness of the Direct Method Cash Flow Statement (available from ssrn.com) (Sept. 15, 1997) (also urging FASB to require the direct method).

120 *See* Michael Schellenger & JoAnn Noe, FASB 95, Cash Flow and Bankruptcy, 18 *J. Econ. & Fin.* (1999).

121 *See* Divesh Shankar Sharma & Errol R. Iselin, The Decision Usefulness of Reported Cash Flow and Accrual Information in a Behavioural Field Experiment (available from ssrn.com) (Nov. 10, 2000) (using actual bankers with at least three years of lending experience and finding that judgments based on cash flow information was

value, when used as a supplemental tool to analyze income statements and the effects of accruals.122 Indeed, institutional regimes ranging from the Delaware Court of Chancery to the World Bank endorse valuation methods using the discounted cash flow technique.123 Ultimately, cash flow is a fact, while earnings are an opinion—true across countries and within countries.124

The cash flow statement cannot stand alone, of course. It is true that past cash flows are a better indicator of future cash flows than are earnings, but predictions can be improved by using the two together.125 On the other hand, evidence suggests that the cash flow statement is superior compared to the balance sheet for measuring accruals as a way to test for the presence of earnings management in the income statement.126

The cash flow statement is subject to negligible debate. Apart from minor and meaningless variance in the three-part classification, majority flexibility on using the indirect or direct method with some countries requiring one or the other, and minor definitional issues concerning cash equivalents, there is little up in the air. A few technical points arise, such as non-articulation between the cash flow statement and various balance sheet items, but none of these impairs either the value of the statement or its transcendent comparability.

Other debates center not so much on whether or how to prepare the cash flow statement but how much information should be included on its face, such as measures of free cash flow, cash flow per share and segment cash flow reporting.127 These are matters mostly of determining what use can be made of the cash flow statement. Cash flow per share, for example, can be determined by a user easily from the statement and the balance sheet without regard to whether the preparer calculates it or whether a particular standard calls for it. The source of disagreement concerns the relative utility of the figure and whether it is considered reliable or potentially misleading in the hands of users. Thus any quarrel is not at all with harmony in the cash flow statement. On the contrary, it reflects unanimity in recognizing that the cash flow statement is designed for users of financial statements—chiefly equity investors and not, for example, for fiscal authorities.

B. Standing

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statistically more significant than judgments based on accrual information and thus endorsing the call of regulators world-wide to mandate statements of cash flow).

122 *See* Scott A. Richardson, *et al.*, Information in Accruals About Earnings Persistence and Future Stock Returns (working paper, Dec. 2002) (available at AlphaSeeker.com).

123 *See M.G. Bancorporation v. Le Beau*, 737 A.2d 513 (Del. Ch. 1999); World Bank, Guidelines on the Treatment of Foreign Direct Investment, 31 *Int'l Legal Materials* 1379 (1992); International Center for Settlement of Investment Disputes (IRSC) Review, *Foreign Investment L.J.* 297 (1992).

124 Pablo Fernandez, Cash Flow is A Fact: Net Income is Just an Opinion (available from ssrn.com) (Sept. 25, 2002).

125 *See* Gopal V. Krishnan & James A. Largay, On the Usefulness of the Direct Method Cash Flow Statement (available from ssrn.com) (Sept. 15, 1997)

126 *See* Daniel W. Collins & Paul Hribar, Errors in Estimating Accruals: Implications from Empirical Research (available from ssrn.com) (Sept. 29, 1999).

127 See Palgrave: United Kingdom, Group Accounting, *supra* at 2669, 2672.

Despite the importance of cash, the cash flow statement is a relatively new event. As of 1992, only the IAS and five countries—all Anglo-American—had completed articulating their cash flow statement standards.128 Market forces began driving leading multinational companies in various countries to voluntarily prepare cash flow statements.129 The regulatory catalyst for global use of the cash flow statement was the 1994 decision of the International Organization of Securities Commissions to declare that the two then-dominant standards (IAS 7 and US SFAS 95) were equivalent; it anointed them with its seal of approval.130

The cash flow statement evolved out of the funds flow statement, which became common in the 1970s and 1980s (though an early use in the UK dates to the financial statements of the Assam Company in 1862).131 But the funds flow statement focused on working capital. It did not encompass all cash activities. It examined sources and application of funds that affected levels of balance sheet accounts, not all sources and uses of cash.

While the UK required a funds flow statement beginning in 1975, it did not require a cash flow statement until 1990. Indeed, the first act of the newly-constituted UK Accounting Standards Board was the publication of Financial Reporting Standard 1, Cash Flow Statements ("FRS 1"). It was inspired by a macroeconomic recession accompanied by a wave of business failures.132

The ASB subsequently revised FRS 1 to more clearly define what constitutes cash equivalents, adopting FRS 10 in 1994 reflecting the revisions and a further issuance in 1996. FRS 1 announces that the purpose of the cash flow statement is to assist users in assessing the company's liquidity, viability, and financial adaptability. Specifically emphasized is the virtue of enabling a user to compare different businesses. The original UK adoption of the cash flow statement as a response to business failures suggests properly that an important function of the statement is to reveal credit quality and liquidity, precisely the sorts of concerns at the forefront of Germanic and Japanese accounting, and an important concern of French accounting.

Germanic use of cash flow or funds flow statements (called *KapitalfluBrechnungenis*) are of recent vintage. In 1988 only ten of the 100 largest German companies reported a funds flow statement and only some of these disclosed cash flow figures and none of 150 medium-sized companies did so.133 By 1995, the year the German HFA endorsed cash flow statements, nearly ¾ of the largest 65 German

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128 *See* Christian Leuz, The Development of Voluntary Cash Flow Statements in Germany and the Influence of International Reporting Standards (Dec. 1999) (available from ssrn.com), at 6.

129 *Id*.

130 The SEC endorsed IAS cash flow statements for use by foreign private issuers. Simplification of Registration and Reporting Requirements for Foreign Companies, Securities Act Release No. 33-7029, 58 Fed. Reg. 60,307-01 (Nov. 15, 1993); *see also* Securities Act Release No. 7053 (Apr. 19, 1994). It subsequently indicated that it would await the full set of IAS before giving its ultimate approval to any portion.

131 *See* Palgrave: United Kingdom, *supra* at 2668.

132 *Id*.

133 *See* Palgrave, Germany, *supra* at 1333.

companies included full cash flow statements.134

The German legislature in 1998 amended the Corporate Code to require a cash flow statement.135 It specifies no particular requirements. Since it was prompted by globalization, German accountants understand that the required cash flow statement is that prescribed by IAS 7 (or SFAS 95).136 German business and accounting professionals adopted recommendations along substantially these lines, though with some minor variation in the design of the statement.137 The adoption and use of the cash flow statement in Germany is uncontroversial—in striking contrast to the true and fair view.138

Cash flow statements are not part of traditional French accounting, and French law does not require cash flow statements for individual accounts.139 The initial move towards cash flow statements followed the typical path that began with using a funds flow statement. It was quickly seen as outdated, analyzing only movements in working capital, and was replaced with a full cash flow statement. The current requirement, adopted for group accounts in 1999 follows SFAS 95 with minor differences.140 It constitutes a "progressive alignment" of French and Anglo-Saxon accounting theory.141

French accountants underscore the significance of the cash flow statement: "the preponderance of cash problems in today's financial management, the need of objective information, the evolution of international practice."142 Nearly all of France's largest 100 corporate groups publish cash or funds flow statements, and the percentage using the old funds flow statement is steadily declining in favor of using the cash flow statement.143

Japanese corporations began using statements of cash flows in 1987, though at the time it was seen as an adjunct to the financial statements and not subject to audit. Since 1999, Japanese law requires the statement, as an integral part of the financial

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134 *See* Christian Leuz,The Development of Voluntary Cash Flow Statements in Germany and the Influence of International Reporting Standards (Dec. 1999) (available from ssrn.com), at 2 (also presenting the results of an extensive multivariate study examining the evolution of cash flow statement use in Germany from 1992-1996 and concluding that the move towards using them responded to pressure from international capital market investors demanding them).

135 Palgrave: Germany: Group Accounting*, supra,* at 1333 (citing HGB § 293, ¶ 1). The cash flow statement requirement applies to individual and group accounts (HGB § 297, ¶ 1 extends the requirement to group accounts). *Id*.

136 *Id*., at 1334

137 *Id*. (citing Schmalenbach-Gesellschaft and the German Institute of Chartered Accountants—S/HFA 1/1995).

138 Palgrave: Germany, at 1334 ("there does not exist any controversial viewpoint concerning the purposes of cash flow statements").

139 Palgrave: Gilbert Gélard, France Individual Accounts, *supra*, at 1108.

140 Palgrave: Jacques Richard, France Group Accountings, *supra*, at 1204-05.

141 *Id*. at 1205.

142 *Id*. at 1205.

143 French, at 1206.

statements.144 An accompanying official statement specifies the purpose of the cash flow statement as revealing the generation and absorption of cash, including cash equivalents. It follows the universal cash flow formatting principles of IAS 7 and other countries, including not only the US, UK, Germany and France, but also the Netherlands, Australia, Spain, and a hundred others. Cash is king, emperor of global accounting, putting global angst over the true and fair view in the distant dust of matters of greatest promise and payoff.

C. Next Steps: Toward A Conclusion

The promise of the cash flow statement for global accounting is substantially being realized. Final steps to completion are the following. First, the remaining 1/3 of IOSCO member countries not having signed onto IAS 7 should do so. This includes the UK and Australia. Second, agreement must be reached—especially with the UK—on the three-part classification, persuading the UK to move from its 8-part classification or perhaps including both. Third, agreement must be reached concerning using the direct or indirect method. For the UK and Australia, adoption would mean permitting either. Better, other members could agree to mandate one or the other—there seems to be substantial agreement among users that the direct method is more useful though corporations at least in the US have preferred to provide the indirect method. Fourth, agreement must be finalized concerning the definition of cash equivalents, a modest but useful loop to close. Fifth, and more a project for users than preparers, is to develop a more uniform catalogue of the uses to which cash flow statement analysis can be directed. Issues include the extent to which such figures as cash flow per share or quality of income should be emphasized as reliable or labeled with caution as potentially misleading.

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144 Palgrave: Japan, Group Accounts, *supra*, at 1857 (citing Articles 8-2 and 76 MOF Consolidation Regulations).