

EFRAG

European Financial Reporting Advisory Group ■



Getting a Better Framework

PRUDENCE

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Published bulletins:

- Prudence
- Reliability of financial information
- Uncertainty



This Bulletin is issued by the European Financial Reporting Advisory Group (EFRAG), the French Autorité des Normes Comptables (ANC), the Accounting Standards Committee of Germany (ASCG), the Organismo Italiano di Contabilità (OIC) and the UK Financial Reporting Council (FRC). The publication of Bulletins is part of their strategy to stimulate debate within Europe, and keep European Constituents informed, as the IASB develops its Conceptual Framework. Any views expressed are tentative: the issuing bodies will develop their final views after considering responses to this Bulletin and other developments in the debate.

Further information about the work of the project partners, including regular newsletters, is available on the partners' websites.

We welcome views on any of the points addressed in this Bulletin. Specific questions are given at the end of the document. Comments should be sent by e-mail to commentletters@efrag.org or by post to

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So as to arrive no later than 5 July 2013.

All comments will be placed on the public record unless confidentiality is requested.

Background

- 1 It has long been established that the idea of prudence (or ‘conservatism’) plays a major part in financial reporting. It is recognised in the EU Accounting Directives which were agreed in the 1970s (see paragraph 3), but its history can be traced back much further. The origins of prudence may, in part, reflect the use of financial statements in showing the amount of profit that is available for distribution.
- 2 The essence of prudence is that assets and income are not overstated and that liabilities and expenses are not understated. The application of prudence ensures that gains are reported only if they are highly probable or reasonably certain (often not until realised) but that (expected) losses are recognised as soon as they are identified. Prudence also causes an asymmetry in the accounting for assets and liabilities, as it requires a higher degree of certainty before recognition of assets than of liabilities. Prudence may affect the accounting policies that determine whether transactions and events are recognised; the measurement of assets and liabilities that are recognised; and the presentation of gains and losses. It may play a role both in the development of accounting standards and, in practice, the preparation of financial statements based on these standards.
- 3 The Fourth EU Directive on Company Law of 1978 requires that “valuation must be made on a prudent basis” and that, in particular, only profits made at the balance sheet date may be included, whereas account must be taken of all losses related to the financial year or to a previous one. This may reflect the view that prudence is necessary to counter the over-statement of income.
- 4 Consistently with the objective of general purpose financial reporting set out in the IASB’s Framework, this Bulletin discusses prudence in the context of financial statements, which are prepared to fulfil the needs of investors and others in making decisions about providing resources to the entity and assessing how efficiently and effectively the entity’s resources have been used. It does not address financial information that may be useful for other purposes such as supervision of financial institutions or monitoring compliance with contracts.

IASC'S FRAMEWORK FOR THE PREPARATION AND PRESENTATION OF FINANCIAL STATEMENTS

- 5 Many believe that prudence contributes to the credibility of financial statements, especially as it provides a high degree of confidence that the net assets represented in the balance sheet are at least as great as their reported amount, and that all reported profits are certain.
- 6 However, just as prudence has a long history, so does the debate about it. The main objection some raise is that prudence introduces bias into reporting, which conflicts with the neutral (or unbiased) view that financial statements should provide. In particular, they argue that prudence may be used to artificially smooth income, reducing profits in good years to provide a cushion that may camouflage the results of poor years, making it difficult to understand the entity's performance. Because it is often difficult for users to detect the exercise of prudence, and to quantify its effect, prudence may impair, in their view, the transparency of financial information.
- 7 In contrast, others believe that the application of prudence results in an earlier reflection of existing risks in the financial statements, preventing the recognition of profits which are not yet realised. They see prudence as the opposite of imprudence, which concept may result in recognising illusory profits and an overstatement of income, and can lead to ill-based economic decisions. In their view, prudence is clearly linked to profit distribution, as noted in paragraph 1, in particular in jurisdictions where legislation has established a direct link between net income and dividend distributions.
- 8 In response to the objection described in paragraph 6, standard-setters, and more specifically the FASB and the IASB, in developing their Conceptual Frameworks, were careful to distinguish between:
 - (i) the deliberate understatement of assets and profits, or overstatement of liabilities and expenses; and
 - (ii) the adoption of a cautious approach in making the judgements necessitated by uncertainty so that assets and income are not overstated and liabilities and expenses are not understated.
- 9 The Frameworks frown upon the former of these and approve the latter. This is the approach to prudence reflected in FASB's Concept Statement 2, which was issued in 1980, and Frameworks issued in the 1980s and 1990s by the Australian standard-setter and the UK ASB. In these Frameworks, prudence is addressed as an aspect of reliability rather than as a 'qualitative characteristic' in its own right. The same approach was adopted in the Framework issued by the IASC in 1989.

- 10 Academic literature also distinguishes conditional conservatism that results in asymmetric timeliness in the recognition of good and bad news (the latter recognised earlier) and unconditional conservatism, which results in systematic understatement of net assets. According to some academic literature, users find early recognition of losses useful, as they are less frequently anticipated by the market than gains. There is a general agreement on the usefulness of conditional conservatism, while unconditional conservatism is more contentious.
- 11 There now seems to be widespread acceptance of the distinction between ‘bad’ prudence (prudence as deliberate misstatement, which is generally rejected) and ‘good’ prudence (prudence as caution, which is generally supported). Hans Hoogervorst, the Chairman of the IASB, has recently described it as ‘plain common sense’.¹ It is playing a role in the IASB’s current work, for example in its projects on revenue recognition and impairment of financial assets. However, even though there is wide agreement that prudence should not go beyond bringing an appropriate level of “caution”, there remain quite divergent views as to what the appropriate level of “caution” is, since it is not a defined term in the Framework. Hence some argue against recording, for example, financial assets at fair value and including the resulting gains in profit when there is no observable price in the market or when the activity in a market is low, as, in their view, this would not reflect an appropriate level of “caution”.
- 12 Both the criticism of prudence as a smoothing device and the acceptance of prudence as ‘a degree of caution’ have a common foundation in the demand that financial statements are based on sound verifiable information that users can depend upon, and thus be assured that the financial statements faithfully portray the economic position of the company, which would make them relevant for users of the financial statements of the company.
- 13 However, some consider that faithful representation, under the application of the prudence concept, means that the recognition of gains should be subject to a high probability realisation threshold. The definition presented in paragraph 8 considers only the understatement and not the overstatement of income. Finally, they believe that the definition of prudence cannot only be based on the objective of reducing earnings management.

¹ ‘The Concept of Prudence; dead or alive?’ Speech given at the FEE Conference on Corporate Reporting of the Future, Brussels, Belgium, Tuesday 18 September, 2012.



IASB'S CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING 2010

- 14 The IASB issued revised Chapters of its Conceptual Framework in September 2010, which establish a decision-useful objective for financial reporting. It is acknowledged that this includes information that is relevant for stewardship (although it avoids the use of that word).
- 15 The new Chapter on Qualitative Characteristics does not include either prudence, or the closely-related concept of reliability. The Basis for Conclusions explains that prudence has been omitted because it is incompatible with neutrality; reliability is said to be ambiguous—it might mean verifiable, free from material error, faithful representation (perhaps combined with neutrality) or precision.
- 16 Instead, the new Chapter includes 'faithful representation'. Information is said to have faithful representation when it 'faithfully represents the phenomena that it purports to represent'. The Framework states that a perfectly faithful representation would be complete, neutral and free from error, although perfection is seldom, if ever, achievable. The Basis for Conclusions states that faithful representation '*encompasses the main characteristics that the previous frameworks included as aspects of reliability*', although it also mentions that '*substance over form, prudence (conservatism) and verifiability, which were aspects of reliability in the previous framework are not considered aspects of faithful representation*'.
- 17 The new chapter on qualitative characteristics also identifies verifiability as an 'enhancing qualitative characteristic'. Verifiability is said to mean that different knowledgeable and independent observers could reach a consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation.
- 18 Some believe that no substantive change has been introduced in the revised Conceptual Framework: the drafting is different, but the underlying idea of prudence remains. This seems consistent with the IASB's Basis for Conclusions, and the views expressed by Hans Hoogervorst in the speech mentioned above.
- 19 Others believe that the changes amount to a change of substance that could harm the accounting model going forward. They take the view that prudence is compatible with neutrality and request that, as prudence is important, the Framework needs to explicitly acknowledge it, because otherwise it will be incomplete.
- 20 And, finally, a third group argues that it is not clear what neutrality means and to what extent prudence should in any case be given prominence. They also believe that the notion of verifiability is too important to be classified as an enhancing characteristic only, and disagree that verifiability is not an aspect of faithful representation.

Prudence within IFRS: some examples



- 21 Prudence is not likely to be useful in solving accounting issues if used alone. The information in financial statements needs to have a number of desirable attributes—‘qualitative characteristics’ in the terminology of the Conceptual Framework: relevance, faithful representation, and/or the enhancing characteristic verifiability. A demand that information be prudent cannot prevail over all other considerations: the challenge is to attain an appropriate balance.
- 22 This is illustrated by the following examples of how some issues are dealt with under current IFRS.
- Under IAS 37, *contingent assets* are not recognised (although they are disclosed), where their realisation is probable, but not virtually certain. On the other hand, liabilities are recognised (and measured prudently) where an outflow is just probable, provided it is more than remote. This demonstrates precisely the asymmetry mentioned in paragraph 2.
 - *Revenue recognition*. Under current practice in IAS 18, revenue is reported when goods are delivered, and generally not when goods remain in inventory. Even when there is little or no uncertainty that goods will be sold at a higher amount, and within an expected short time frame (and even if orders for them have been received), goods are reported at cost (or even net realisable value if lower). The recognition of profit is therefore constrained by a degree of prudence in that it is dependent on the realisation of an event – to simplify: the delivery.
 - A different approach is taken to *construction contracts* under IAS 11 where the percentage of completion method is usually considered superior to the more prudent completed contract method. This may be because the contracts are longer term than those under IAS 18 and they have other characteristics which enable an entity to recognise profit over time. However, use of the percentage of completion method is constrained by prudence, for example by requirements that the eventual outcome of the contract be measured reliably and the reported revenue reflects performance in the period.
 - *Onerous contracts*. IAS 37 requires that a provision is recognised where the unavoidable costs of meeting the obligations under a contract exceed the benefits expected to be received. Except in the case of certain financial instruments, no asset is recognised where the expected benefits exceed the costs.
 - *Revaluation of property, plant and equipment*. Under IAS 16, there is an option to revalue property, plant and equipment to its fair value. This appears to be less prudent than recognition at cost. However, the resulting gain is reported in other comprehensive income rather than in profit or loss. This may be seen as a case where prudence is reflected in presentation.



- *Investment properties.* IAS 40 allows essentially the same option for investment properties as property, plant and equipment. However, in contrast to IAS 16, IAS 40 requires all gains (and losses) arising on a revaluation to be reported in profit or loss.
- *Financial instruments.* A strict application of prudence under IAS 39 or IFRS 9 would not permit recognition of a gain arising upon remeasurement of derivatives or other financial instruments. Some note that there may be different considerations in relation to prudence when fair valuing instruments where the market is illiquid, which do not arise in a deep and liquid market. However, where assets are stated at fair value both gains and losses are recognised, so, it cannot be said that the policy of using fair value is, considered as a whole, imprudent. This departure from the model used in revenue recognition in respect of the timing of recognising profits may depend on the business model or other characteristics of the instruments or their specific markets.
- *Own credit risk.* Under IAS 39, some liabilities are measured at fair value with changes in the “own” credit risk of the issuer recognised in profit or loss. Whilst this has been primarily opposed for lack of relevance, i.e. recognising a profit generated by the deterioration of an entity’s own financial situation, some rejected it also for prudence reasons, when considering such gain in isolation. The IASB has addressed the concerns expressed about the lack of relevance in IFRS 9 by requiring both gains and losses arising from changes in own credit risk to be reported in other comprehensive income.
- *Agriculture.* Some have highlighted the undesirable consequences of fair valuing bearer biological assets as they grow before entering into production under IAS 41. They noted that this distorts income recognition on the duration of the economic cycle of the related agricultural activity (for example plantations of palm trees) by recognising significant profit in the early years, before the first cash inflows arise. Some others believe that recognising income that might reverse subsequently is not prudent. The IASB is currently reviewing the existing standard.

23 There are, of course, many possible views as to the appropriate accounting treatment in these cases. They can be summarised in the following three categories:

- Some believe that prudence should always prevail over the other qualitative characteristics in the Conceptual Framework;
- Others believe that as long as you meet these characteristics, you do not need to worry about prudence; and
- A third group thinks that an appropriate balance needs to be struck.

WORK ABOUT TO COMMENCE

- 24 The IASB has now begun work on the remaining parts of its Framework. Whilst the previous revisions were developed jointly with the US FASB, the IASB plans to undertake this alone, although national standard-setters will be consulted.
- 25 The IASB has indicated that the main focus of this work will be on elements, measurement, presentation, disclosure and the reporting entity. Its programme does not envisage that the recently revised chapters will be reconsidered, and so it seems that it does not consider that reinstatement of the concept of prudence should be contemplated. It must, however, be possible that work on new subjects will show that some amendments to the recently-issued chapters are necessary.
- 26 Some may consider that the most important point is that the Framework should allow an appropriate role for prudence. In their view, whether or not prudence is explicitly identified as a qualitative characteristic is less important.
- 27 Others may consider that recognising that prudence should play a role implies that it has to be explicitly mentioned in the Framework.
- 28 The following considers the implications that prudence (and the related concept of reliability) may have on the new parts of the Conceptual Framework.

ELEMENTS: RECOGNITION OF ASSETS AND INCOME

- 29 The current Framework defines assets and liabilities first. The other elements (equity, income and expenses) are defined in terms of assets and liabilities. The following paragraphs assume that this basic structure is retained.
- 30 Prudence requires that outflows of cash (or other assets) are reported as expenses unless an asset has been acquired in exchange. For example, development costs are recognised as expenses unless there is clear evidence that the benefit of those costs will be received in a future period.
- 31 This requires a robust definition of assets. In addition, the current Framework requires that assets are recognised only where recognition criteria are met. This acknowledges that some items that meet the definition of an asset are irrelevant or incapable of reliable measurement: examples include some intangible assets, especially those that are generated by the firm itself rather than purchased.
- 32 Ensuring that this aspect of prudence is preserved will require that any new definition of an asset is unambiguous and robust and that appropriate recognition criteria are maintained.



MEASUREMENT

- 33 Prudence also requires that assets are not written up unless there is adequate evidence of the increase in value. It is also necessary to ensure that the measurement basis to be used is relevant in the circumstances of the reporting entity. A value, for example, might not be relevant if the entity is unable or very unlikely to capture that value through sale of the asset or otherwise, for example by using the asset in its operations. This is related to the debate about the role of the business model in financial reporting, a topic which will be addressed in a future publication by EFRAG and its partners.
- 34 It will also be important that the Framework's prescriptions on measurement require appropriate recognition of impairment—both for financial and non financial assets.



REPORTING OF FINANCIAL PERFORMANCE

- 35 Prudence does not necessarily ensure that the income reported in financial statements is sustainable. Prudence may require the recognition of non-recurring losses, for example when assets are impaired. Prudence can also have the effect of distorting reported performance as prudent accounting applied in an earlier accounting period reverses. Thus even if prudence has a part to play in developing a satisfactory approach to the reporting of financial performance, other factors will also need to be considered.
- 36 It is well known that there is no clear rationale that explains why some items of income (and expense) are excluded from profit and loss, and reported in other comprehensive income instead, but some take the view that prudence may play a part. IASB has used this type of accounting in its development of IFRS 9 on financial instruments. Developing principles for this is one of the priorities of the part of the Conceptual Framework that deals with presentation. It will also be necessary for the Framework to address whether income and expenses that are initially reported in other comprehensive income should be 'recycled'—that is, reported in the profit and loss account of a subsequent accounting period, for example the period in which it is 'realised'.



DISCLOSURES

- 37 As usually described, prudence concerns the recognition of assets and gains, and liabilities and losses. However, prudence may also be expected to be relevant to what is disclosed in the footnotes to financial statements. For example, as argued in the July 2012 Discussion Paper *Towards a Disclosure Framework for the Notes*, issued jointly by EFRAG, the ANC and the FRC, it may be necessary to disclose the circumstances of a large unusual gain (even when the item is already disclosed as a separate line in the income statement), to avoid the incorrect inference that it is of a recurring nature.



OUR TENTATIVE VIEW

- 38 In this Bulletin, we have described that prudence, although widely accepted as a concept, continues to give rise to diverse views, since not everyone today exercises the degree of “caution” in the same way. This variety of views plays a role in the decisions to be made, in the context of the revisions of the Conceptual Framework, about recognition, measurement, presentation and disclosures. Therefore, it is in our view useful that, in making these decisions, the role of prudence is explicitly considered.

**We would welcome views on any of the points addressed in this Bulletin.
In particular:**

- (i) Is there a role for prudence in the development of accounting standards? If so, should it (i) focus on recognition and measurement criteria, and the timing of recognition of gains and losses; or (ii) be described as the general exercise of caution?**
- (ii) Does the current Framework adequately reflect the essence of prudence, or do you share the tentative view that its role should be explicitly considered? If so, how would you characterise the level of caution you believe should be observed? References to various views in the bulletin would be helpful.**
- (iii) Are there requirements in current IFRS not mentioned in this Bulletin which fail to reflect prudence? Are there requirements in current IFRS which in your view are overly prudent?**
- (iv) Do you have any other comments on this Bulletin?**

Comments should be addressed to: commentletters@efrag.org, so as to be received before 5 July 2013.

