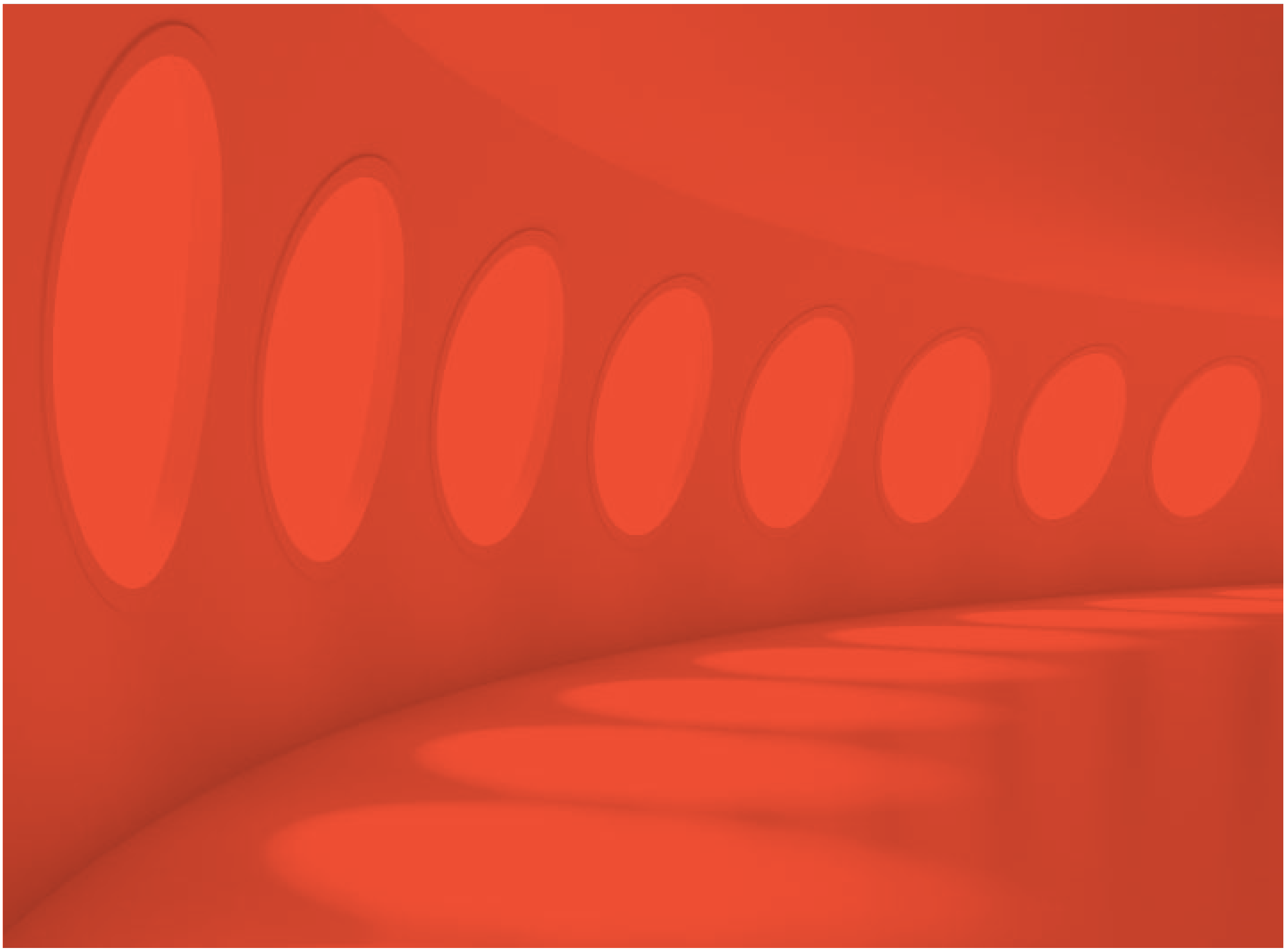
ACCA

Prudence and IFRS



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ACCA (the Association of Chartered Certified Accountants) is the global body for professional accountants. We aim to offer business-relevant, first-choice qualifications to people of application, ability and ambition around the world who seek a rewarding career in accountancy, finance and management.

Founded in 1904, ACCA has consistently held unique core values: opportunity, diversity, innovation, integrity and accountability. We believe that accountants bring value to economies in all stages of development. We aim to develop capacity in the profession and encourage the adoption of consistent global standards. Our values are aligned to the needs of employers in all sectors and we ensure that, through our qualifications, we prepare accountants for business. We work to open up the profession to people of all backgrounds and remove artificial barriers to entry, ensuring that our qualifications and their delivery meet the diverse needs of trainee professionals and their employers.

We support our 170,000 members and 436,000 students in 180 countries, helping them to develop successful careers in accounting and business, with the skills needed by employers. We work through a network of 91 offices and centres and more than 8,500 Approved Employers worldwide, who provide high standards of employee learning and development.

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To further its work, ACCA has developed an innovative programme of global forums which bring together respected thinkers from the wider profession and academia around the world.

The ACCA Global Forum for Corporate Reporting
The Forum's role is to Influence the development of financial and non-financial reporting around the world. It aims to identify and evaluate the various ways in which corporate reporting can add value to investors, businesses and the public. It also addresses the issues and challenges that surround the adoption of international financial reporting standards around the world.

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In this paper ACCA's Global Forum for Corporate Reporting reviews the arguments for and against prudence in accounting standards. It summarises the debate about whether International Financial Reporting Standards, as the key global standards, should include prudence and state its importance in their conceptual framework.

FOR MORE INFORMATION CONTACT

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Prudence in accounting and financial reporting has a long-established track record. There is a considerable debate about whether International Financial Reporting Standards (IFRS), as the key global standards, should include prudence and state its importance in their conceptual framework.

This debate has been triggered by, for example, dissatisfaction with IFRS's role in the prelude to and the fall-out from the financial crisis – did a lack of prudence in the IFRS help create the over-exuberance of expansion, unrealised profits, unjustified bonuses and dividends? Another trigger was the elimination of prudence from the part of the IFRS conceptual framework introduced in 2010, ironically just after the crisis.

Up to then prudence had been included in the IASB's framework in the discussion of the qualitative characteristic of reliability, and was defined as:

> the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets and income are not overstated and liabilities or expenses are not understated.

Other frameworks have used similar definitions. The 2013 EU Accounting Directive states that:

> recognition and measurement shall be on a prudent basis, and in particular only profits made at the balance sheet date may be recognised…

Prudence in accounting can be viewed both as something that should be embedded in the standards themselves, but then also exercised by preparers when applying those standards. The exposition of prudence in the former IFRS framework above quite clearly refers to caution in the application of the standards' requirements in cases of uncertainty, but what is more in question is how much it is needed in setting those requirements in the first place. Yet the EU Accounting Directive states that prudence is a fundamental principle that will affect the setting of the requirements.

There is also the issue of excessive prudence. The former IFRS framework went on to say that:

> however, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses…

Clearly, there are notions of 'good' and 'bad' prudence, though the line between them might look difficult to draw.

ARGUMENTS FOR…

There is clearly an expectation among many users that accountants and their accounts are, or should be, a restraint on the anticipated over-exuberance of management in reporting a company's results. This is tied in with an expectation both that the reported and audited numbers are 'hard' and, certainly, that caution has been exercised when making estimates, as referred to by the former framework, and that the accounting standards should be supporting this. This view seems to be held not just by the general public, but also by some professional investors, particularly in relation to profits as a basis for paying bonuses and dividends.

Certainly, it is where profits and assets have been overstated – and not where they have been understated – that accounts, accountants and accounting standards have received the most criticism. There is an asymmetrical risk that prudence in both standard setting and application is helping to redress. The financial crisis in 2008/9 is the latest example – more prudent accounting by banks might have restrained excessive bonuses and dividends, made for more resilient banks and provided greater financial stability to the whole economic system.

The benefits of the exercise of prudence in the application of the standards are perhaps more widely agreed upon. For example the chairman of the IASB has described the definition of prudence in the IASB's former framework as 'sheer common sense'.

…AND AGAINST

In fact, the main arguments against prudence concern the neutrality and comparability of the resulting financial statements. Other professional investors, for example Chartered Financial Analysts (CFA), want management to report the actual results in a transparent manner that is not biased but neutral to both good and bad news. Where there are uncertainties they would like management's best estimate with the appropriate disclosures of the basis on which this has been made.

When challenged over the desirability of restraint in profit recognition it is often pointed out that while prudence may hold back profits in one year such restraint may simply lead to their release in a subsequent period which as a result will show exaggerated results. Daimler Benz's restatement of its profits record from (prudent) German accounting to US GAAP for its New York listing illustrated this 'smoothing' effect of prudence very well. The Spanish banks and the dynamic provisioning during the crisis are cited as a further case in point – prudent reserves temporarily masked their underlying weakness as conditions changed, and delayed remedial action.

Responding to the financial stability and bank resilience arguments above, it could be said that these concerns are wrongly laid at the door of financial reporting. These should be the remit of the rightly named prudential regulators, requiring extra reserves for stability reasons. The role of financial reporting is to provide the investors and capital markets with as transparent and true a picture as possible. The tension between these two forces was palpable in the crisis, but continues with the ECB's 2013 asset quality reviews, which require 'a conservative application of IFRS' in determining write-downs.

Finally, if there is to be prudence – how much? The problem with prudence is determining how much downward bias has been used in measuring the assets by Company A compared with its competitor B. How much prudence is required in the standards? This is the same issue as the difficulty of drawing a line between 'good' prudence and 'bad' prudence noted above. In countries that have had avowedly prudent accounting, such as Germany and Switzerland pre-IFRS, investors and creditors could supposedly take some comfort from knowing there were hidden reserves. In fact, when these companies transferred to more transparent accounting under IFRS the size of those reserves, in some cases, turned out to be disappointingly small.

BUT IS PRUDENCE ALREADY INCLUDED IN IFRS?

Notwithstanding the arguments above, prudence is already well embedded in the existing IFRS. Many instances of this are cited, including those listed below.

The basic principle of revenue recognition in IAS18 requires that goods need to have been transferred or services provided before a profit is recognised. It is not sufficient that there are firm orders and inventory available to fulfil them for the profit on the transaction to be recognised and inventory transformed into a receivable.

Furthermore if, on the other hand, there are onerous rather than profitable contracts then under IAS37 full provision must be made for the all the expected losses, whether items have been delivered or not.

IAS37 also includes the asymmetric treatment of contingencies as between positives and negatives. Contingent assets can only be recognised in the accounts if their receipt is virtually certain, whereas contingent liabilities must be recognised if the outflow of resources is more likely than not.

There are other assets where the IFRS criteria prevent their recognition – such as internally generated intangibles of all kinds – or provide greater thresholds of probability for them, such as with the capitalisation of development costs.

Most assets are recognised at historical cost, and the basic principle is that declines in value must be recognised immediately as impairment, but increased values are not recognised until the asset is sold.

On the measurement of assets and liabilities using cash flow or fair value models (for instance level 3 values under IFRS13), the additions to discount rates for illiquidity and risk are arguably examples of prudent requirements.

Forms of presentation may be seen as reflecting prudence – for example the treatment of depreciation of property, plant and machinery as part of the profit for the year, while the recognition of revaluation surpluses is treated more prudently as other comprehensive income (OCI).

Disclosures in the notes to the accounts of sensitivities of valuations to changes in assumptions can be seen as prudent.

Most accountants and users of accounts would agree with these treatments as instances of prudence that are appropriate. It can be noted that most of these are cases where prudence is applied to the recognition of assets and liabilities and few of them apply to the measurement of items.

On the other hand, certain accounting treatments are sometimes viewed as not prudent, such as:

- fair values, especially when based on models for items that are not realisable in a liquid market and especially when the gains are recognised in the profit for the year rather than through OCI
- the revenue recognition model in IAS11 for taking profit on construction contracts on the basis of a percentage of the completion value
- not allowing provisions for future costs even when these are very likely to occur – such as maintenance provisions.

Nonetheless, it is worth noting in the first two of these cases that the 'imprudent' recognition is tempered by requirements for prudence in the measurement of Level 3 assets and restrictions on the income recognition when measures are less than reliable.

PRUDENCE IN THE CONCEPTUAL FRAMEWORK

As prudence is apparently reflected in the standards it seems right that its role is discussed in the framework that is used to set those standards.

The latest discussion paper on the framework from IASB does not, however, propose its inclusion. Moreover, that discussion paper is proposing the removal of the probability of inflow/

outflow of economic benefits from the definition of assets and liabilities and that very specific recognition tests should not be provided. For assets, in particular, this opens up the scope for including more items as assets than under current IFRS. Instead, the relevance of the information provided will be considered and uncertainty is likely to be taken into account in measuring items rather than in deciding whether they will be recognised in the first place.

ACCA would agree that uncertainty needs to be reflected in measurement. In fair values based on models and values based on future cash flows (including impairments of assets at cost) the uncertainties must be fully recognised, for instance in the risk or liquidity components of discount rates. The conclusion from the instances in the current IFRS would be that the framework needs to have an element of prudence in the recognition of assets and liabilities rather than just to reflect uncertainty in measurement. Prudence in recognition of assets and liabilities should be more transparent than potentially unquantified prudence in measurement. The accounting standards make clear which items should be recognised and when, and the accounting policies should elaborate on how those standards have been applied by the company.

As the IASB Discussion Paper sets out, many items ought to be measured at cost and this automatically brings in an element of prudence in the values recognised and the timing of profit recognition, as noted above. Beyond that, prudence in fair value or cash-flow-based measurement is not helpful. This is where it becomes hard to deny the arguments that prudence leads to unquantified bias in accounts. Reflecting uncertainty in measurement, on the other hand, is an attempt to reflect honestly what market players apply in practice and what economics would dictate.

Some current instances of reflecting prudence in the presentation of financial statements are based on the recognition of some gains in OCI rather than in profit. There is an acknowledged lack of clarity in the principles of what constitutes profit and what constitutes OCI – principles of which prudence is just a part, and this still remains to be resolved in the framework.

ACCA'S CONCLUSIONS

There are arguments for and against prudence in accounting standards, and these principally focus on the tension between user expectations that financial information should be a reliable record of performance and the need for them to be unbiased. There is 'good' and 'bad' prudence. What is clear is that there are many examples of prudence in existing IFRS and that these instances are widely accepted treatments.

Given those instances, the following conclusions can be drawn.

Prudence certainly should be discussed in the new framework when the exposure draft is produced. The previous wording is quoted above, but this seems to refer principally to the prudent application of the standards more than prudence's role in setting the standards in the first place.

The discussion and definition should be reconsidered as arguably the principal role for prudence in standard setting lies in robust recognition criteria for assets and liabilities, where its application is transparent.

In measurement terms the retention of historical cost for many items will impart a proper degree of prudence to profit recognition and to asset values. Other measurement bases such as fair value need honest application of the valuation techniques, giving due recognition to the effects of uncertainty. Standards should not inject an extra element of prudence into these valuations, which will always tend to lead to an unquantified element of bias.

Standards provide guidance but their application often involves a degree of judgement, which allows for a range of outcomes largely because of uncertainty. In exercising that judgement management should err on the side of caution and prudence.

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