STAFF PAPER

May 2014

REG IASB Meeting

Project	**Conceptual Framework**		
Paper topic	Prudence		
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Purpose of paper

1. The purpose of this paper is to discuss whether and, if so, how to reintroduce a reference to prudence into the *Conceptual Framework*.

Summary of staff recommendation

2. The staff recommend that the Exposure Draft of the *Conceptual Framework* should:
    - (a) reintroduce a reference to prudence in the *Conceptual Framework*;
    - (b) describe prudence as the exercise of caution when making judgements under conditions of uncertainty to ensure that assets or income are not overstated and liabilities or expenses are not understated;
    - (c) discuss in the Basis for Conclusions on the *Conceptual Framework* the need for:
        - (i) preparers to exercise prudence in preparing financial statements; and
        - (ii) the IASB to exercise prudence when setting standards;
    - (d) explain that prudence is consistent with neutrality and does not allow for the deliberate overstatement of liabilities or expenses or understatement of assets or income.

Structure of paper

3. This paper is structured as follows:

   (a) background (paragraphs 4-10);

   (b) feedback (paragraphs 11-18);

   (c) analysis (paragraphs 19-36);

   (d) staff recommendation and question for the IASB (paragraphs 37-39);

   (e) possible amendment to IAS 1 (paragraph 40).

Background

4. Both Chapter 3 of the existing *Conceptual Framework* and the *Framework for the Preparation and Presentation of Financial Statements* ('pre-2010 *Framework*') state that financial statements should be neutral, that is, free from bias. However, the pre-2010 *Framework* went on to describe the concept of prudence. Chapter 3 does not include any reference to prudence.

5. Paragraph 36 of the pre-2010 *Framework* describes neutrality and paragraph 37 describes prudence:

> **Neutrality**
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> 36 To be reliable, the information contained in financial statements must be neutral, that is, free from bias. Financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgement in order to achieve a predetermined result or outcome.
>
> **Prudence**
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> 37 The preparers of financial statements do, however, have to contend with the uncertainties that inevitably surround many events and circumstances, such as the collectability of doubtful receivables, the probable useful life of plant and equipment and the number of warranty claims that may occur. Such uncertainties are recognised

> by the disclosure of their nature and extent and by the exercise of prudence in the preparation of financial statements. Prudence is 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 or income are not overstated and liabilities or expenses are not understated. 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, because the financial statements would not be neutral and therefore, not have the quality of reliability.

6. Hence, the pre-2010 *Framework* expressed the view that the exercise of prudence need not be inconsistent with neutrality.

7. In developing Chapter 3 of the *Conceptual Framework*, the IASB removed reference to the concept of prudence. The Basis for Conclusions on Chapter 3 explains that prudence was not included as an aspect of faithful representation because:

   (a) including a reference to prudence would be inconsistent with neutrality. Even with the prohibitions against deliberate misstatement that appeared in the pre-2010 *Framework*, a requirement to be prudent would lead to bias in the preparation of financial statements.

   (b) deliberately understating assets or overstating liabilities in one period often leads to overstating financial performance in later periods.[1]

8. The International Public Sector Accounting Standards Board's *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities* issued in 2013, does not identify prudence as a separate qualitative characteristic of useful information. However, that Framework does call for the exercise of caution when dealing with uncertainty and the Basis for Conclusions (BC3.17) explains:

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1 See paragraphs BC3.27–BC3.29 of the existing *Conceptual Framework*.

> The IPSASB is of the view that the notion of prudence is also reflected in the explanation of neutrality as a component of faithful representation, and the acknowledgement of the need to exercise caution in dealing with uncertainty. Therefore, like substance over form, prudence is not identified as a separate qualitative characteristic because its intent and influence in identifying information that is included in [general purpose financial reports] is already embedded in the notion of faithful representation.

9. The overall approach to Chapters 1 and 3 was discussed at the Advisory Council meeting in June 2013. Some Advisory Council members expressed the view that prudence, reliability and stewardship should be discussion in the *Conceptual Framework* Discussion Paper.

10. Prudence was discussed in Section 9 of the Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* (the 'Discussion Paper'). We asked whether respondents agreed with the IASB's proposal not to fundamentally reconsider Chapters 1 and 3. We did not ask a separate explicit question on prudence.

Feedback

11. Although we did not ask an explicit question on prudence, many respondents commented on the issue.

12. Some stated that prudence should not be reinstated in the *Conceptual Framework*. Reasons cited include the following:

    (a) There is no common understanding of what the term means. Different parties interpret it differently. Consequently, including the word in the *Conceptual Framework* could lead to inconsistent application.

    (b) The exercise of prudence will lead to bias in the financial statements and is inconsistent with neutrality.

    (c) The exercise of prudence in one period could lead to the overstatement of performance in subsequent periods.

(d) Users of financial statements are aware of the potential for management bias towards optimism and adjust for it. The exercise of prudence leads to greater subjectivity in the financial statements that can make it difficult to assess an entity's financial performance.

(e) Prudence should be applied by investors and regulators when analysing entities. It should not be applied by the IASB in setting standards.

13. One user group argued that support for prudence is, for many, a means of reducing or rejecting fair value measurements and stated it would be more useful to have an open debate on fair value rather than have to have the debate indirectly through a debate on prudence.

14. However, many commenting on this issue (including many user groups) stated that prudence should be reinstated. Reasons cited include the following:

(a) Prudence is used in both existing and proposed Standards. It is therefore important to explain it in the *Conceptual Framework* so that it can be applied consistently.

(b) Prudence is needed to counteract management's natural bias towards optimism.

(c) Investors are more concerned about downside risk than upside potential. Prudence helps address this concern.

(d) Academic research has suggested that 'conditional conservatism' (defined as the more timely recognition of losses than gains) has a role to play in financial reporting.

(e) The exercise of prudence helps to align the interests of shareholders and managers and can reduce moral hazard.

(f) The financial crisis has demonstrated the need for prudence when making estimates.

15. A number of different interpretations of the word prudence were suggested by respondents including:

    (a) caution under conditions of uncertainty. Of those suggesting that prudence should be reinstated, many interpreted prudence this way and suggested that the pre-2010 definition of prudence should be used;

    (b) different recognition thresholds for assets and liabilities;

    (c) the need for greater evidence regarding the existence of assets and income than for liabilities and expenses;

    (d) the more timely recognition of liabilities and expenses than of assets and income;

    (e) a conservative bias in recognition and measurement;

    (f) unrealised gains should not be recognised;

    (g) likely losses should be recognised as early as possible; and

    (h) prudence is a state of mind rather than a characteristic of financial information.

16. Many respondents stated that, if prudence is reintroduced into the *Conceptual Framework*, the IASB needs to clearly define what is meant by the term. Of those who view prudence as the exercise of caution under conditions of uncertainty, many state that the IASB should clarify that the use of prudence does not mean:

    (a) systematic overstatement of losses and liabilities and understatement of assets and income;

    (b) smoothing of reported profits;

    (c) a prohibition on the use of fair value measurements; or

    (d) prudence as exercised by prudential regulators.

17. Many supporters of reintroducing prudence expressed the view that the exercise of prudence is not necessarily incompatible with the concept of neutrality. However, some supporters of reintroducing prudence question whether neutrality in financial reporting is achievable or appropriate.

18. Prudence was discussed at the Accounting Standards Advisory Forum (ASAF) meeting in September 2013:

(a) Most ASAF members stated that the IASB should at least debate reintroducing the notion of prudence in the *Conceptual Framework*. However, they noted that the term 'prudence' can mean different things to different people, so it would be important to define clearly what the term means.

(b) ASAF members also stated that the exercise of prudence should not be allowed to lead to systematic bias in the financial statements. Instead, many ASAF members stated that prudence should be described as the exercise of caution under conditions of uncertainty.

(c) Some ASAF members stated that prudence should only be reintroduced if the exercise of prudence could be shown to provide better information to users of financial statements.

(d) Many ASAF members expressed their preference for reintroducing the concept of prudence into the *Conceptual Framework*. However, other ASAF members noted that if prudence were reintroduced, steps would need to be taken to ensure that the exercise of prudence would not create opportunities for earnings management.

(e) Some ASAF members questioned whether the reintroduction of prudence would have any practical effect on the IASB's decisions. These ASAF members suggested that the same standard-setting outcome could be achieved by focusing on the needs of users rather than reintroducing prudence.

Analysis

19. The IASB could decide not to reintroduce a reference to prudence. Reference to prudence was removed from the *Conceptual Framework* because of concerns that it could be interpreted in a way that is inconsistent with neutrality and could lead to earnings manipulation. Not reintroducing a reference to prudence would avoid those concerns. In addition, the decision to remove the reference to prudence went

through extensive due process and was agreed with the FASB. Any decision to reinstate could lead to divergence from the FASB.

20. However, the decision to remove the reference to prudence has clearly generated significant debate. Consequently, this paper analyses whether it would be possible to reintroduce a reference to prudence without undermining the concept of neutrality and without providing opportunities for earnings manipulation.

21. Paragraphs 23-31 discuss the different ways in which preparers might exercise prudence.

22. Paragraphs 32-36 discuss how the IASB might exercise prudence.

Preparers

23. Many of the respondents to the Discussion Paper who commented on prudence believe that preparers should exercise prudence:

    (a) when selecting an accounting policy (for example, when a Standard provides a choice of accounting policies);

    (b) when developing an accounting policy in situations when no specific Standard applies; and

    (c) in applying the accounting requirements of a particular Standard.

    However, there are different views on what it means to exercise prudence.

24. Many respondents to the Discussion paper expressed support for the description of prudence in the pre-2010 *Framework* (see paragraph 5).

25. The pre 2010-description of prudence appears to be aimed mainly at preparers and describes prudence as the exercise of caution under conditions of uncertainty such that assets or income are not overstated and liabilities or expenses are not understated. It also explains that the exercise of prudence does not allow for:

    > …the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because the financial statements would not be neutral and therefore, not have the quality of reliability.

26. The staff believe that the pre-2010 requirement to exercise prudence was not intended to introduce systematic bias into the financial statements. Overall the financial statements should be free from bias (neutral). This view is supported by the fact that the discussion of prudence in the pre-2010 *Framework* appears to be a continuation of the discussion of neutrality (see paragraph 5). However, this requirement for caution under conditions of uncertainty reflects the fact that management may have a natural bias to optimism – that is, they may tend to overstate assets or income and understate liabilities or expenses. Consequently, there is a need, when there is uncertainty about either the recognition or measurement of an item, to exercise caution. When there is no uncertainty, there is no opportunity for management to introduce bias and hence there is no need for prudence.

27. The staff believe that a requirement for preparers to be prudent can be reconciled with the concept of neutrality as long as it is viewed as a way of counteracting any bias to optimism. The overall aim would still be to produce financial statements that are without bias (ie neutral). However, to achieve this, we would remind preparers to exercise caution under conditions of uncertainty to ensure that assets or income are not overstated and liabilities or expenses are not understated.

28. However, some respondents have suggested that being prudent should go further than simply exercising caution under conditions of uncertainty. They believe that preparers should be required to exercise a systematic bias when preparing financial statements such that assets and gains are understated until realised and liabilities and losses are overstated. In addition, some state that preparers should be permitted to override the requirements of the Standards if they do not result in 'prudent' financial statements.

29. Those who support reintroducing prudence as a systematic bias in financial reporting argue that it:

(a) results in financial statements that are more reliable;

(b) reflects the view that investors are more interested in downside risk than upside potential;

(c) helps ensure that dividends and management bonuses are not paid out of unrealised profits.

30. However, the staff believe that a requirement for preparers to use a systematic bias when preparing financial statements:

(a) would be inconsistent with the need for financial statements to provide a faithful representation of the financial performance and position of a reporting entity;

(b) could lead to earnings management which has the potential to make financial statements less rather than more reliable (for example, creating excessive provisions in one period can mask negative performance in future periods);

(c) would lead to greater subjectivity that would make financial statements less understandable;

(d) would be inconsistent with neutrality.

31. In addition, the staff note that:

(a) When developing Standards, the IASB will consider what information is relevant to investors including whether they are more interested in downside risk than upside potential.

(b) Permitting preparers to override the requirements of Standards if they do not result in 'prudent' financial statements would result in financial information that is more subjective and less comparable.

(c) While we appreciate that the IFRS reported numbers serve an important role in determining dividends and management remuneration, the IFRS financial statements are only one of the factors that need to be considered:

(i) Whether an entity can pay dividends is largely dependent on local laws and regulations rather than on the accounting requirements (although there may be a link to reported profits).

(ii) The objective of general purpose financial statements is not to determine amounts that can be used without further analysis to make decisions about the remuneration of management and the level of bonuses. It is the responsibility of those who determine remuneration and bonus policy to decide which inputs are most suitable for this purpose in the context of the entity's own corporate governance arrangements.

IASB

32. As discussed above, the requirement to exercise prudence in the previous *Conceptual Framework* seemed to be aimed more at the preparers of financial statements than at the IASB when setting Standards. However, some have suggested that prudence has a role to play when the IASB is developing new or revised Standards and that this should be acknowledged in the *Conceptual Framework*.

33. It has been suggested that the following are examples of when the IASB (or its predecessor organisation) has set standards that have prudent outcomes:

    (a) The use of cost-based measurements (including impairments). Cost-based measurements lead to the recognition of losses (impairment) but do not result in the recognition of increases in value.

    (b) Asymmetric recognition thresholds for assets versus liabilities. For example, contingent assets are recognised only when an inflow of economic benefits is virtually certain but contingent liabilities are recognised when an outflow is probable;

    (c) The non-recognition of some gains. For example, the exclusion of some estimates of variable consideration from the transaction price in the proposed revenue recognition Standard.

34. The staff disagree with the idea that the IASB would need to invoke the notion of prudence in order to justify standard setting decisions to use cost-based measurements. When selecting a measurement basis, the IASB considers which measurement basis would provide the most useful information to users of financial statements. In some cases, that might be fair value (where both increases and reductions of value are recognised): in others, that might be a cost-based measurement (where, prior to realisation impairments are recognised but not gains). Once a measurement basis has been selected, it should be applied

neutrally. (We will ask the IASB to discuss selection of measurement bases in July.)

35. Asymmetric recognition thresholds and the non-recognition of some gains could be described as resulting from prudence in standard setting. However, the situations when the IASB decides to introduce requirements of this type are the exception rather than the rule. In general, a non-biased (neutral) depiction of the assets, liabilities, gains and losses of an entity will provide users with relevant information and our standards reflect this. Consequently, we do not think it is appropriate to introduce a general requirement for the IASB to exercise a systematic bias in standard setting. We do not, for example, think that the IASB should embed asymmetric recognition criteria in the *Conceptual Framework*.

36. However, the staff believe that the IASB, when setting standards, needs to consider the possibility that management may have a natural bias to optimism. The staff believe that the IASB should seek to counteract any such bias and promote the preparation of financial statements that provide a neutral depiction of an entity's financial performance and financial position. To achieve this the IASB should exercise prudence by developing rigorous standards that are intended to result in financial statements in which assets or income are not overstated and liabilities or expenses are not understated.

Staff recommendation and question for the IASB

37. The staff believe that the concept of neutrality can be reconciled with the exercise, by both preparers and the IASB, of prudence that counteracts the incentives that exist for management to present an optimistic picture of an entity's financial performance and financial position.

38. We, therefore, recommend that you:

    (a) reintroduce a reference to prudence in the *Conceptual Framework*;

    (b) describe prudence as the exercise of caution when making judgements under conditions of uncertainty to ensure that assets or income are not overstated and liabilities or expenses are not understated;

(c) discuss in the Basis for Conclusions on the *Conceptual Framework* the need for:

(i) preparers to exercise prudence in preparing financial statements; and

(ii) the IASB to exercise prudence when setting standards;

(d) explain that prudence is consistent with neutrality and does not allow for the deliberate overstatement of liabilities or expenses or understatement of assets or income.

39. The appendix to this paper includes draft wording that could be used to implement this recommendation.

Question 1

The staff recommend that the Exposure Draft of the *Conceptual Framework* should:

(a) reintroduce a reference to prudence in the *Conceptual Framework*;

(b) describe prudence as the exercise of caution when making judgements under conditions of uncertainty to ensure that assets or income are not overstated and liabilities or expenses are not understated;

(c) discuss in the Basis for Conclusions on the *Conceptual Framework* the need for:

(i) preparers to exercise prudence in preparing financial statements; and

(ii) the IASB to exercise prudence when setting standards;

(d) explain that prudence is consistent with neutrality and does not allow for the deliberate overstatement of liabilities or expenses or understatement of assets or income.

Do you agree?

Possible amendment to IAS 1

40. The *Conceptual Framework* is not a Standard and does not impose requirements on preparers. Consequently, there is a risk that preparers might overlook a

reference to prudence in the *Conceptual Framework*. This problem could be avoided if the requirement to exercise prudence was also included in a Standard - for example, IAS 1 *Presentation of Financial Statements*. The staff will present a paper at a future meeting that discusses whether, in addition to any amendment to the *Conceptual Framework*, IAS 1 should be amended to include a requirement for preparers to exercise prudence.

Appendix

A1. Possible wording for Chapter 3. Additions to the existing text are underlined.

> QC14 A neutral depiction is without bias in the selection or presentation of financial information. A neutral depiction is not slanted, weighted, emphasised, de-emphasised or otherwise manipulated to increase the probability that financial information will be received favourably or unfavourably by users. Neutral information does not mean information with no purpose or no influence on behaviour. On the contrary, relevant financial information is, by definition, capable of making a difference in users' decisions.
>
> <u>QC14A Neutrality is supported by the exercise of prudence. Prudence is the exercise of caution when making judgements under conditions of uncertainty to ensure that assets or income are not overstated and liabilities or expenses are not understated. 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, because the financial statements would not be neutral and, therefore, would not faithfully represent the entity's financial performance and financial position.</u>

A2. Possible wording for the Basis for Conclusions on Chapter 3

> BCX Prudence was removed from the *Conceptual Framework* in 2010 because of concerns that it was inconsistent with neutrality and could lead to earnings manipulation. However, the IASB was persuaded by those who argued that the exercise of prudence by both preparers and the IASB could be reconciled with the

concept of neutrality. Financial reporting takes place in an environment that, in some circumstances, contains incentives for management to, intentionally or unintentionally, introduce bias in financial statements. Prudence is consistent with neutrality to the extent that prudence counteracts the incentives that exist for management to introduce an optimistic bias when representing an entity's financial performance and financial position. Consequently, the IASB [proposes] to reintroduce a reference to prudence in the *Conceptual Framework*.

BCXA Preparers exercise prudence by exercising caution when making judgements under conditions of uncertainty such that assets or income are not overstated and liabilities or expenses are not understated. The IASB exercises prudence by developing rigorous Standards that are intended to result in financial statements in which assets or income are not overstated and liabilities or expenses are not understated. However, the overall aim of both the IASB and preparers is to present a neutral depiction of the entity's financial performance and financial position. Prudence does not allow a preparer to deliberately understate assets or income or deliberately overstate liabilities or expenses. Nor does it mean that IASB should set requirements that systematically understate assets or income or systematically overstate liabilities or expenses. In both cases, the resulting financial statements would not be neutral and, therefore, would not faithfully represent an entity's financial performance and financial position.