

The Concept of Prudence: dead or alive?

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Ladies and gentlemen, I am grateful to the Federation of European Accountants for the opportunity to participate in today's conference. As has often been said, Europe kick-started the move towards global accounting standards when it and others adopted IFRSs from 2005. The accounting profession in Europe played a vital role in the success of this project. I and my fellow members of the IASB are extremely grateful to FEE and its membership for leading this important work.

The theme of today's conference is corporate reporting of the future. There could be no better time to consider such a topic. In the last ten years we have seen nothing short of a revolution in financial reporting. Ten years ago, no one used international standards. Today, companies in more than 100 countries do so, including almost three quarters of the G20. Against any measure, this has been quite an achievement.

So, after the revolution, what comes next? What is the future of corporate reporting? There are various initiatives trying to address this question. One of the most important is the work to take a more holistic view of corporate reporting, known as integrated reporting. The goal of integrated reporting is to bring together many reporting requirements including sustainability, the environment, social issues as well as of course financial reporting. These topics are becoming more inter-dependent, and many investors want to understand the interplay between them. I also think for investors to properly understand financial statements, they are in need of non-financial key performance indicators. For example, a company might decide to cut back sharply on training and education of its employees. This decision might make its next quarterly statement look good, but it could be disastrous for long-term profitability. For all these reasons, I support this important initiative and am I happy to serve on the governing council of the IIRC.

While financial reporting is much further developed than integrated reporting, we are still struggling with very fundamental questions. Our Conceptual Framework has definitions of assets and liabilities, but we still do not find them completely satisfactory. While you

would expect accountants –of all people- to be able to make a clear distinction between mine and thine, we are still not quite sure how to distinguish equity from liabilities. Measuring the performance of an entity is also very hard. We measure Net Income, but then there is also Other Comprehensive Income, which keeps on growing without us being sure what it means.

These are all the thorny issues that we need to resolve in the next phase of the revision of our Conceptual Framework. We are planning to write new chapters on elements, measurement and presentation, including a solid disclosure framework. This is perhaps the most important work we can undertake. Get the underlying concepts right, and you have sound and consistent reference points for the rest of our standard-setting work.

The significance of this work is underlined by the fact that up to this day, the existing Conceptual Framework is still the subject of intense controversy. I am referring specifically to the Concept of Prudence. When the IASB revised the first chapters of the Conceptual Framework in September 2010, it replaced the concept of Prudence by Neutrality. Ever since, IFRSs have been periodically criticized for actually being imprudent, allegedly leading to overstated profits and/or understated liabilities. For example, critics blame the incurred loss model for understating losses on bad loans and the use of fair value accounting for inappropriately recognizing unrealised profits.

This criticism needs to be taken seriously. In previous speeches, I have spoken about the fact that financial reporting is far from an exact science and that it is highly dependent on judgement. If these judgements will systematically err on the side of optimism, obviously the investor will be very poorly served. Exaggerated profits inevitably lead to overpriced investments.

But before I examine the question whether IFRSs lead to imprudent financial reporting or not, let us first try to determine what Prudence actually means. The previous version of our Conceptual Framework listed Prudence as a characteristic of Reliability (which is now called Faithful Representation). The Framework said that Prudence was 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.

You might very well ask what the heck was wrong with this definition of Prudence? My answer would be: absolutely nothing. The definition basically says that if you are in

doubt about the value of an asset or a liability it is better to exercise caution. This is plain common sense which we all should try to apply in our daily life.

While cautioning against overly rosy assumptions, the old definition of Prudence also contained a clear warning against creating hidden reserves and excessive provisioning. This warning was basically designed to prevent cookie jar accounting and income smoothing. Again, I agree 100 per cent.

There are two problems with excessive conservatism. First of all, during an economic upturn, profits are artificially depressed and investors might miss out on a good investment opportunity. But the biggest problem kicks in during the downswing of the economic cycle. In those circumstances, hidden reserves can be used to artificially increase an entity's earnings. Profits are overstated, masking the deterioration of the entity's performance. Again, the casualty is transparency. The investor is likely to be misled and might be induced to hold on too long to his investments.

More generally, cookie jar accounting undermines confidence in the reliability of financial reporting. In 1993, DaimlerChrysler of Germany acquired a secondary listing in the United States. In its conversion to US GAAP, voluminous hidden reserves became transparent in Daimler's financial statements. Although Daimler's financial position was much better than previously reported, it led many to wonder how the lack of transparency provided by the then German GAAP affected other German companies. People know that hidden reserves can easily turn into hidden losses.

So I think that the old definition of Prudence, stressing caution while warning against cookie jar accounting, was spot on. Why then did we remove it?

One reason was convergence with US GAAP, which did not have a definition of Prudence. More generally, many felt that in practice the concept of Prudence was often used as a pretext for cookie jar accounting. In this respect, it is important to realise that the incentives for earnings management are huge. Remuneration and reputations are very much dependent on steadily rising earnings figures. Accordingly, the ability to smooth earnings is highly prized by executives.

Even analysts are often (wittingly or unwittingly) sympathetic to accounting techniques that allow for some earnings management. Predicting earnings is the bread and butter of analysts and too much volatility makes that very hard to do! Given all these temptations, both the IASB and FASB felt it was important to stress the neutrality of financial

reporting, by leaving out the concept of Prudence. In this context, I find this a defensible decision.

It is also easy for me to accept the revised Conceptual Framework since the old concept of Prudence –if in doubt, be cautious- is still very much engrained in our standards. Let me just give you a few examples:

- While fair values are often seen to be synonymous with exuberance, in IFRS 13 we actually require risk adjustments when fair values are measured using mark-to-model techniques.
- Our standards require liabilities to be recorded for guarantees or warranties, even when they have not yet been called in.
- Inventory is typically carried at lower of cost or net realisable value; again a prime example of exercising caution.
- Impairment tests are required to ensure that the carrying amount in the statement of financial position is not greater than the recoverable amount of the asset
- IFRSs also have very strict rules governing the balance sheet presentation, giving little room for off-balance sheet financing.
- As is well known, our standards are quite restrictive in terms of the netting of derivatives. The difference with entities reporting under US GAAP can be as big as 30 or 40% of the balance sheet. We believe derivatives are too important –and their net positions too volatile- to be relegated to the notes.
- The upcoming leasing standard is another effort to make off-balance sheet financing more transparent. Analysts around the world routinely adjust the balance sheet for leases that they perceive to be off-balance sheet financing. It is highly prudent that we are going to enshrine this in our standards.
- Equally, our consolidation rules, based on the principle of control are very strict. Rather than choosing for a bright line, we opted for a qualitative principle which may require consolidation, even if a company's interest is less than 50%.

Given all these examples, it is not surprising that the British government recently stated that it “does not accept that IFRS has led to a loss of prudence”, saying “the concept of

prudence continues to permeate accounting standards”. I believe this to be an appropriate conclusion.

Having said so, I think there is further room for improvement of our standards with the old concept of Prudence in mind. In a previous speech, I have mentioned the risks associated with intangible assets. They are undeniably there, but measuring them is often a huge challenge.

In this respect, I have specifically mentioned my concerns about goodwill resulting from business combinations. This goodwill is a mix of many things, including the internally generated goodwill of the acquired company and the synergy that is expected from the business combination. Usually, there is real value there, but nobody knows exactly how much. Most elements of goodwill are highly uncertain and subjective and they often turn out to be illusory.

Given its subjectivity, the treatment of goodwill is vulnerable to manipulation of the balance sheet and the P&L. In normal circumstances, you would expect at least part of the goodwill to be written off gradually, as the expected synergies for which goodwill was paid are being realized. But in practice, entities might be hesitant to impair goodwill, so as to avoid giving the impression that they made a bad investment decision. Newly appointed CEO’s, on the other hand, have a strong incentive to recognize hefty impairments on their predecessor’s acquisitions. Starting with a clean slate, they can more or less ensure a steady flow of earnings in the future. The question is if our current rules provide sufficient rigor to these decisions.

There is no simple solution to these problems. It might be worthwhile to take a fresh look at the impairment rules during our upcoming post-implementation review of IFRS 3 *Business Combinations*, but I am the first to acknowledge this will be very challenging indeed.

I mentioned before that a frequent criticism of fair value accounting is that it would lead to inappropriate recognition of unrealised profits. I believe this criticism is mostly unfounded. It should be noted that fair value measurement is often much quicker in picking up deterioration than amortised cost; just look at recent write-downs of Greek debt. Nevertheless, I am sure that the treatment of unrealized versus realised earnings will be an important issue in our future work on the new Measurement chapter of the Conceptual Framework.

A final example of our efforts to build sufficient caution into our standards is our work on an expected loss model for financial instruments. After the outbreak of the financial crisis, our current impairment model, which was based on incurred losses, was criticised for being too little, too late. Both the IASB and the FASB have indeed come to the conclusion that we need a more forward-looking impairment model. In the past 18 months we have worked hard to come to a converged solution.

As you know, the FASB recently developed second thoughts about the model we had jointly developed and a converged solution now seems unlikely. Whatever the final outcome of our deliberations, though, both approaches will be based on expected losses and both should be more responsive to changes in credit expectations than what we have now.

Both models will also share the main drawback of any expected loss model: namely, increased subjectivity. Obviously, estimation of expected losses will require more judgement than measuring incurred losses. Reliability can be a real issue.

To the IASB, it is important that the expected loss model meets two conditions: first, it should reflect economic reality as closely as possible and second, it should keep leeway for earnings management as small as possible. Let me expound a little bit on both issues.

If the expected loss model is to reflect economic reality, it should keep recognition of losses on day-1 to a minimum. Obviously, when a loan is made on market terms, at inception a loss is not suffered. To recognise lifetime losses on day 1 could bring the book value of a loan (significantly) below its economic value. For non-investment grade loans to small and medium-sized companies, which are quite common, these day-1 losses could be quite substantial. Investors would rightly be very suspicious of such numbers.

A model that leads to day-1 expected losses across the board, could also have serious, unintended consequences. When earnings are depressed, cutting back on new lending (and thus avoiding day-1 losses) would be a very easy way for banks to boost their profits. Bank lending might become even more pro-cyclical than already is the case!

Moreover, a model that is based on expected lifetime losses on day 1 will necessarily be highly subjective, even if they are based on historical statistics. Such statistics can indeed be very treacherous, as both the American and Spanish mortgage markets have shown. Minor tweaks in lifetime expected losses can have a very big impact on earnings. The temptations of earnings management will be hard to resist.

Again, while steep provisioning might be conservative on day 1, they might serve to mask a deteriorating performance on day 2. For this reason, the Financial Crisis Advisory Group concluded in its final report of June 2009 that, although an expected loss model seems more prudent than the incurred loss model, the Boards must take care to avoid fostering earnings management which would decrease transparency. Given the fact that I was co-Chair of the FCAG, you will not be surprised that I wholeheartedly support this conclusion.

For these reasons, our model requires recognition of full lifetime losses only after a loan has suffered deterioration. In the jargon of our proposal: a loan is impaired when it has experienced a more than insignificant deterioration and when it has become reasonably possible that contractual cash flows will not be fully collected. This threshold is much lower than in the current incurred loss model, but it avoids the pitfalls of full lifetime losses on day 1. We acknowledge that our model also requires the use of judgement and will not be completely free of subjectivity. We are still working hard to develop proper application guidance so as to keep the room for subjectivity as limited as possible.

Let me try to come to a conclusion. I think I made it clear in this speech that I think it is absolutely vital that our standards result in information that is as neutral as possible. A systemic bias towards conservatism undermines the value of earnings as a performance indicator. I have also shown my understanding for the fact that IASB felt a need to be completely unambiguous about this issue by removing the Concept of Prudence from our Conceptual Framework.

Yet, I have also demonstrated that the basic tenets of the Concept of Prudence are still vital for our work. Indeed, the exercise of caution is visible in many of our standards and is also an important issue in the development of new standards. Indeed, one might very well conclude that the old Concept is not dead, but alive and kicking indeed. From what I have said, it will be clear that I have absolutely no problem with that. As the old Gospel says: “old time religion, it’s good enough for me.”

Ladies and gentlemen, thank you for your time. I wish you a very successful conference.