A tale of 'prudence'

It may seem obvious that prudence is a desirable thing when preparing financial information; after all, would you wish for imprudent accounting? However, establishing the characteristics of useful financial reporting has long proved difficult and controversial. Until 2010, prudence was included in the International Accounting Standards Board's (IASB) *Conceptual Framework* (see figure 1). In the 2010 revision we removed the reference to prudence, but we are now proposing to put prudence back. So why is the IASB seemingly so indecisive? And why should investors care?

The IASB has just published an Exposure Draft of a revised *Conceptual Framework for Financial Reporting*. In it, the IASB proposes to reintroduce prudence as one aspect of the characteristics that make financial statements useful to investors. At first glance, this may sound an obvious and straightforward decision; prudence is, after all, long recognised as a virtue in everyday life.

Sadly, the application of prudence to the world of accounting is trickier than it is to an individual's conduct. At the heart of the IASB's challenge lies the definition of the word. What does 'prudent' mean in relation to financial reporting? In the 'history of prudence' (see figure 2, page 3), I describe the ambiguity of the definition used in the past. The confusion caused by this ambiguity prompted the IASB to remove any reference to prudence in 2010, when the *Conceptual Framework* was last revised, preferring to rely on other ways of describing what we mean by good-quality financial reporting.

However, in response to our Discussion Paper on the *Conceptual Framework*, published in 2013, a number of stakeholders, including some investors, told us that accounting standards should be founded explicitly on the concept of 'prudence'. And so, in our Exposure Draft we are now seeking to explore how we might helpfully reintroduce the term.

Steve Cooper

A member of the IASB explains the IASB's proposals on prudence

Figure 1. What is the Conceptual Framework?

The *Conceptual Framework for Financial Reporting* describes the objective of and concepts for general purpose financial reporting; it deals with issues such as the definitions and measurement of assets and liabilities and when and how income and expenses should be recognised and presented.

The *Conceptual Framework* also includes a discussion of the necessary (and in some cases desirable) characteristics of useful financial information. To be useful, financial statements must provide information that is relevant and faithfully represents the economic activity it depicts. Prudence is one possible component of these characteristics and has attracted much attention.

Prudence in practice

The various dictionary definitions of prudence are all very similar, with references to synonyms such as ‘careful’, ‘cautious’, ‘wise’, ‘well judged’ and ‘circumspect’.

Applying these dictionary definitions to financial reporting, however, is not so easy. Few would disagree that management should be careful and considered when arriving at the figures presented. Good judgement is particularly important in financial reporting, because many amounts require estimation.

But it is important to understand the context within which these judgements are made. Management teams making accounting estimates are subject to many incentives that could lead them to favour either an overstatement or an understatement of financial position and financial performance (in other words, to introduce a bias into financial reporting). For example, an overstatement of financial performance may avoid the negative consequences for management of reporting poor performance, whereas an understatement of financial performance in a good year may provide management with reserves that can be used to smooth reported profits and thereby avoid reporting poor performance in the future. For investors using financial statements to make decisions on their investment, any deliberate over- or under-statement is likely to lead to suboptimal decisions and a misallocation of capital.

It therefore seems to me that prudent and well-considered estimates should be neither overstated nor understated. I am sure few would support an accounting framework that allowed bias and manipulation of financial results by management.

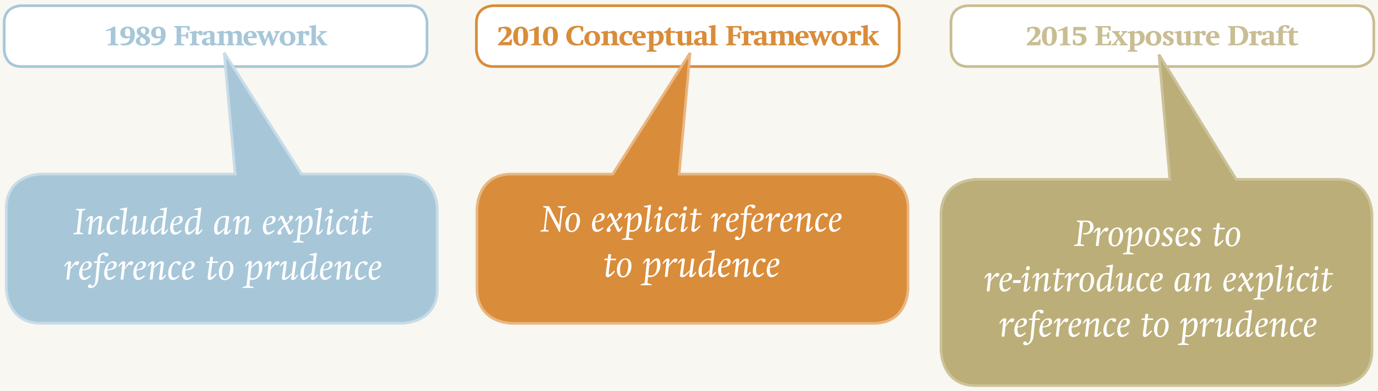
The IASB has always recognised the desirability of avoiding a bias in the preparation of financial statements, which is why ‘neutrality’ is, and always has been, included in the IASB’s *Conceptual Framework* as a feature of useful information. We regard neutrality as a necessary component of providing a faithful representation of the underlying economics. For example, when measuring the depreciation of a fixed asset, management must estimate the useful economic life of that asset. Investors should be able to expect that such estimates are realistic, well-judged and without bias. The word prudent seems to be entirely consistent with such an estimate and also entirely consistent with the desire for neutrality. There should be prudent but unbiased estimates of the useful lives of fixed assets.

However, not everyone believes the discussion above captures the most desirable interpretation of prudence in financial reporting. In the last couple of years, I have talked to many investors and other people about prudence. While few question the desirability of some form of prudence, the interpretation of the word differs markedly. I would broadly categorise the people I have talked to into two camps:

- those who favour a conservative bias in financial reporting (conservative accounting); and
- those who wish financial statements to represent a company’s financial results ‘neutrally’, without any systematic bias (neutral accounting)—my own personal preference. This means avoiding the dangers of an optimistic bias, but also not introducing the equally damaging implications of a negative bias.

For investors using financial statements to make decisions on their investment, any deliberate over- or under-statement is likely to lead to suboptimal decisions and a misallocation of capital.

Figure 2. A history of prudent accounting



Much of the current confusion regarding prudence arises because the definition used in the pre-2010 *Conceptual Framework* was ambiguously drafted and its implications in practice were uncertain.

Part of that old definition clearly focuses on uncertain estimates: *"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, ..."*

Some argue that this definition was in effect asking for a conservative bias (a bias towards understatement of net assets) in the judgements made in financial reporting. The definition continues, *"... 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."*

This second part of the pre-2010 definition does further underscore the IASB's commitment to neutrality. However, it does so in a way that leaves room for debate. Some reading this passage have argued that there seems to be more emphasis on not overstating assets and profit, compared with what they see as less emphasis on avoiding understatement of assets and income. This is in spite of the explicit reference to neutrality.

It is certain that the old definition was not entirely clear in the eyes of our constituents and that, irrespective of that definition, there were different views about the implications of prudence in financial reporting and whether, and if so when, a conservative bias was desirable. In changing the *Conceptual Framework* in 2010, the IASB could have tried to clarify the meaning of prudence to eliminate the differences in interpretation or alternatively simply delete references to the concept altogether and try to describe in other ways the desirable characteristics of good quality financial reporting. Because of the 'baggage' that seemed to come with the word, we decided at the time to choose the latter course of action. However, considering the controversy this has caused ('if accounts are not prudent they must therefore be imprudent') we have reconsidered, and in this Exposure Draft propose the alternative of retaining (reintroducing) the concept but clarifying exactly what we mean by it.

Conservative accounting

It seems to me that many of the investors who argue for a conservative bias in the recognition and/or measurement principles applied in financial reporting are often thinking beyond making estimates for the purpose of preparing financial statements that give the most relevant information to investors and the most realistic representation of the reporting entity's activities. They believe that financial reporting needs to also take into account other consequences of those reported amounts. These consequences include using financial statement information to help determine dividend payments to shareholders, bonus payments to management and the amount of capital a company is required to maintain. In each of these cases, the consequences of overestimating assets and profit may be more severe than the consequences of underestimates. They argue this asymmetry of consequences should drive an asymmetry of accounting.

For example, paying a dividend is much easier than raising additional equity capital in a future period. If, therefore, a dividend is paid but it turns out with hindsight that the business is undercapitalised, it may be difficult to raise the additional capital needed. The adverse consequence of an undercapitalised business (business disruption and possible insolvency) may be more damaging that that of an overcapitalised business (an inefficient use of capital and a lower rate of return to investors).

For this reason, a conservative dividend policy and conservative approach to business capitalisation may well be desirable.

One way to achieve this may be to apply more conservative recognition or measurement approaches to assets and income than to liabilities and expenses. For example, reporting profits only once all business risks related to a particular activity have been resolved might help to guard against excessive distributions. It is not surprising that those who have been most vocal about prudence are also vocal about dividend distributions and capital maintenance.

There are a couple of difficulties, however, with this approach. First, how much conservatism is necessary in financial reporting in order to achieve the desired outcome in respect of, say, distribution policy? Secondly, is conservative accounting really the best way of constraining 'imprudent' dividend distributions or ensuring that businesses are adequately capitalised?

It is also important to remember that applying a conservative bias would be likely to provide investors with information that is less relevant for their capital allocation decisions, unless somehow they knew the degree of bias being applied and could therefore make their own corrections.

Although a conservative bias in financial reporting might possibly help conserve capital, does this possible advantage outweigh the disadvantage of compromising on the information provided to investors to help them make decisions on where to invest—especially as there are other ways of securing that advantage?

It is interesting to note that although reported profits may well be a relevant consideration, governments do not base regulation of dividend distributions or capital adequacy solely on financial reporting. For example, distributable profits may be defined to exclude recognised profits that have greater measurement uncertainty, such as unrealised value changes that are not evidenced by observable prices, as is the case in the UK. There is also a wider fiduciary duty on management to safeguard the business and ensure adequate capitalisation, all under the intense scrutiny of shareholders. Additionally, in sectors where the adverse consequence of undercapitalisation is particularly damaging, such as banking and insurance, a separate system of 'prudential' regulation is used. In such regulation, the neutral financial statement data is often adjusted to reflect a more conservative view. Of course the use of the word 'prudential' in this context unfortunately contributes to the confusion about the word prudence in financial reporting.

If prudence is defined as a systemic bias towards the understatement of net assets, and this is regarded as a desirable characteristic of financial statements, then any measurement or recognition basis that produces lower net assets or profit should presumably always be preferred, even if the resulting information is less relevant to investors. Taken to the extreme, this leads to very odd results. In my earlier example of estimating the useful life of a fixed asset, a prudent/conservative approach would presumably lead to depreciation over a useful life that is shorter than the useful life that is actually expected; but how much shorter? The only way to truly ensure that the estimated life is not longer that the eventual actual outcome would presumably be to use a useful life of zero and hence immediately recognise all fixed asset purchases as an expense. It is difficult to see how this would provide a faithful representation of the underlying economics.

Neutral accounting

After much debate about prudence, the IASB proposes in the current Exposure Draft to reinstate the concept of prudence and define it in a manner that is consistent with neutrality (see figure 3). Our aim is that this definition will be clearer than that in the pre-2010 Conceptual Framework. A 'basis for conclusions', explaining the thinking behind the IASB's proposals, will help clarify further both what the IASB intends and what it does not intend.

I believe that it is very important that management do not prepare financial statements with an optimistic bias. Choosing estimates that are constantly at the optimistic end of the range of plausible values is unlikely to result in financial statements that faithfully represent that business.

Many investors have argued that an explicit reference to prudence can help to counteract the natural optimism of management; I agree with this assessment. Prudence can therefore be seen as reinforcing a true adherence to the principle of neutrality in financial reporting. It is a reminder that there needs to be a solid basis for accounting estimates and it gives auditors a basis to challenge numbers and 'kick the tyres' on behalf of investors.

However, taking a pessimistic view when making estimates of assets and profit can be just as damaging for investors. Not only does it give investors poor information in the current period, but it can be used by management to mask a deterioration in the business in future periods.

The solution is to apply IFRSs in a prudent but neutral and unbiased manner.

Figure 3. The proposed definition of prudence in the new Exposure Draft

In the current Exposure Draft of a revised *Conceptual Framework* the IASB proposes to define prudence as follows:

2.18 Neutrality is supported by the exercise of prudence. Prudence is the exercise of caution when making judgements under conditions of uncertainty. The exercise of prudence means that assets and income are not overstated and liabilities and expenses are not understated. Equally, the exercise of prudence does not allow for the understatement of assets and income or overstatement of liabilities and expenses, because such mis-statements can lead to the overstatement of income or understatement of expenses in future periods.

The Basis for Conclusions also includes the following explanation of the reasons for the reinstatement of prudence.

BC2.10 Therefore the IASB, in paragraph 2.18 of the Exposure Draft, proposes to reintroduce the term prudence, defined as cautious prudence, in the Conceptual Framework*. It notes that the removal of the term prudence in the 2010 revisions led to confusion, and perhaps has exacerbated the diversity in usage of this term. People continue to use the term, but do not always say clearly what they mean. In addition, some have claimed that, because the term was removed, financial information prepared using IFRS is not neutral but is in fact imprudent. The IASB thinks that reintroducing the term with a clear explanation that caution works both ways (so that assets and liabilities are neither overstated or understated) will reduce the confusion.*

We need your views

Would it be a wise decision to reinstate a reference to prudence and to clarify it? We hope that the exposure and public consultation that we are now undertaking will give us useful information to guide our discussions on this question. No doubt many will advise that we were right to remove it in 2010, because of the confusion over its interpretation, and will object that reinstatement is a backward step that will simply create more confusion. Others may say that the IASB has not gone far enough in the new Exposure Draft and that the definition of prudence should accommodate a degree of conservative bias in financial reporting, as I have outlined above.

What do you think? Would we be right to reinstate a reference to prudence? Have we defined prudence appropriately? We would like to hear views and comments from investors both on the topic of prudence and on the many other important topics included in the proposed updated *Conceptual Framework*. We are seeking comments by 26 October 2015.

Get in touch

To submit a comment letter, please visit: **go.ifrs.org/comment_CF**

If you would like to discuss this topic or other areas of accounting, please contact:

Steve Cooper at scooper@ifrs.org or
Barbara Davidson, IASB Investor Liaison, at bdavidson@ifrs.org