UKSA

For members of the
International Accounting
Standards Board

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This is a Commentary, written by Roger Collinge FCA on behalf of UKSA, on Steve Cooper's "A tale of prudence" which was published as an IASB Investor Perspective in June 2015

1. The IASB and Prudence- their worries

Members of the International Accounting Board (IASB) have great difficulty with the term 'prudence'. Quite understandably they have sought to produce standards which give a depiction which is "*complete, neutral and free from error*".[1]

Their problems are in general these.

- They see the term prudence as clashing with the term neutral.
- They are worried that being prudent is biased and therefore not neutral.
- They are worried that excessive prudence will lead to profit smoothing ("cookie jar" accounting in American parlance).
- They feel the need to be prescriptive, with the aim of reducing the need for individual judgement by preparers and auditors.
- They have assumed that the future can be usefully foreseen and have not recognised that it is always uncertain.
- They expect managements to take a detached view of the estimates needed to prepare accounts and fail to recognise that managers are, and need to be, naturally optimistic.
- They have an inbuilt contradiction in their standards in that, when they seek an assessment of future cash flows from an asset and that assessment results in an amount <u>above</u> cost, that amount is <u>not</u> brought into account, but if the amount is <u>less</u> than cost that asset is regarded as "impaired" and written down. This is sometimes called "recognition asymmetry"[2]. It subverts the concept of neutrality.
- They explicitly state that their "Conceptual Framework" (CF) is not a standard. It is in this CF that the term prudence is to be reintroduced and thus the status of the term will be unclear.

[1] See the Exposure Draft of the Conceptual Framework. May 2015. (ED) para 2.15 .
[2] E.G Marshall-Lennard personal paper March 2014

- IASB members also say in the "Basis for conclusions" to the Conceptual Framework (BC) that the term prudence is now defined as "cautious prudence" (BC 2.10). This muddies the water, in that the Exposure Draft (ED) actually defines the term "prudence" not "cautious prudence" (ED 2.18). "Cautious prudence" sounds like super prudence, which is certainly not neutral. The definition of prudence given is *"the exercise of caution when making judgements under conditions of uncertainty"*.

Prudence and its role in accounting is further discussed by an IASB member Steve Cooper in the Investor Perspective "A tale of prudence" of June 2015.

2. A possible way out

2 .1 Uncertainty and prudence versus neutrality

The IASB states that prudence is *"the exercise of caution when making judgements under conditions of uncertainty".* This definition clearly presumes that there can be conditions where there is no uncertainty. It is this presumption that is mistaken. UKSA has previously laid out arguments to show that there cannot be conditions <u>without</u> uncertainty. Further comments on this point were made in an article in Economia, the ICAEW magazine, in June 2015:

- *"The world is too complacent and too many people spend too much time projecting the past into the future."*
- *"And that is the key problem with black swan events: the past is no guide to what happens next."* [3]

From this it follows that prudence – ie a degree of caution- should be applied to judgements made in <u>all</u> conditions.

Cooper argues that the definition of prudence prior to 2010 (almost identical to what is now being suggested – see last bullet point in section 1 above) *"was ambiguously drafted".* Some, he says, thought that it was asking for a *"conservative bias"* and thus not *"neutral"* in IASB terms. The IASB assumes that bias can be avoided by calculating expected cash flows and fails to recognise that those cash flows are inherently uncertain. Thus it can be said that a failure to allow for such uncertainty is, in itself, a form of bias - proper and realistic judgements cannot be made without an allowance for uncertainty.

If this approach is taken the apparent clash between prudence and uncertainty disappears.

2.2 Profit smoothing

Judgement will always be required. The future is uncertain. The avoidance of profit smoothing requires clear accounting in the disclosure and use of provisions against assets and strong auditing. Thus the standards need to make clear that undervaluation of assets is equally unacceptable. The reinstatement of the concept of prudence into the CF will strengthen the hand of auditors against both over-optimism and under-valuation.

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[3] - See more at: http://economia.icaew.com/business/june-2015/how-to-protect-against-black-swan-events?

2.3 Management optimism

Business people are and need to be naturally optimistic. Nobody goes into business expecting to make a loss. Such optimism is essential if new products are to be developed and economic growth achieved. Thus there needs to be a counterweight to that optimism and that is where the concept of prudence comes in. Cooper refers to this in his paper at page 5.

2.4 Detailed prescriptiveness

The IASB is seeking accounts that are comparable. Comparability is said to be *"an enhancing qualitative characteristic"*. Part of that comparability it believes can be obtained by highly prescriptive standards. This has driven out willingness and also perhaps the opportunity to use judgement. The IASB needs to acknowledge that judgement cannot be excluded and that terms such as *"expected cash flows"* are inherently judgemental. The standards need to encourage questioning of such expectations, not the acceptance of them as a given based on a trend derived from history which is still quite recent. History does not travel in a straight line.

2.5 Recognition asymmetry.

An assumption that one should not anticipate profits was historically the norm. The IASB needs to recognise this explicitly. If such *"recognition asymmetry"* is appropriate in some areas of accounting, it is difficult to justify fair value accounting which introduces profits not yet made. Not anticipating profits on stocks, for example, is accepted but is certainly not neutrality. Having different approaches in this area worsens comparability.

2.6 The status of the Conceptual Framework

One wonders, why is the CF not accorded the status of a standard? Is it that IASB members cannot agree amongst themselves as to what those concepts are, or is it a fear that they will not be able to follow such a CF in all cases and that would highlight deficiencies in their logic? It is surely essential that any body of work which purports to have underlying concepts, as IFRS do, should genuinely and fully acknowledge those concepts.

3 "A tale of prudence"

What follows are detailed comments on Steve Cooper's article in Investor Perspectives, published in June 2015, explaining the IASB's proposals on prudence.

3.1 Page 1 ; Cooper states that the IASB, when deleting reference to prudence in 2010, preferred to *"rely on other ways of describing what we mean by good-quality financial reporting*". This seems to mean that the concept of prudence was in his view still there, but the word itself was not used - a strange approach to the subject.

3.2 Page 1; figure 1: Cooper suggests that *"prudence is one possible component"* of the characteristics of useful information. That it is described as a "possible" component is troubling, particularly as his tale starts by saying *"It may seem obvious that prudence is a desirable thing when preparing financial information"*. In the view of the UK Shareholders' Association (UKSA), prudence is not just possibly desirable but absolutely <u>essential</u>.

3.3 Page 4: Cooper discusses the possibility that unthinking use of what he believes to be *"the most realistic representation of the reporting entities activities"* (ie the IASB view) may lead to adverse consequences (principally on capital maintenance). He comments that there is an argument that what he calls conservative accounting should be used on this ground alone. UKSA does not agree with this. We believe that the legal requirement for a true and fair view must prevail.

Capital maintenance is crucial but a demonstration of this can be achieved – at least as a minimum – by requiring the disclosure of realised profits [4]. Alternatively, the presentation of a profit and loss account on the basis of realised profits, with a separate statement of the results of using "fair" values, may be a better way of demonstrating that capital is being maintained.

3.4 Overall

There is a way out of the apparent logical trap of trying to say that prudence is neutral.

- Proper recognition of the uncertainty of the future requires the use of a prudent approach.
- Such proper recognition will then achieve the "neutrality" that the IASB seek and
- this will result in more reliable accounts
- which will be more likely to achieve that legally required, "true and fair" view.

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[4] A present project of the FRC Financial Reporting Lab