STAFF PAPER

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

1. This paper discusses whether any changes are needed to the discussion of prudence in the *Conceptual Framework for Financial Reporting* (the *Conceptual Framework*) in response to the feedback received on the Exposure Draft *Conceptual Framework for Financial Reporting* (the Exposure Draft).

Summary of staff recommendation

2. The staff recommend:
   (a) confirming that the revised *Conceptual Framework* should include a reference to prudence described as the exercise of caution when making judgements under conditions of uncertainty, as proposed in the Exposure Draft;
   (b) including in the *Conceptual Framework* an acknowledgement that accounting policies that treat gains (or assets) and losses (or liabilities) asymmetrically could be selected if their selection is intended to result in relevant information that faithfully represents what it purports to represent;
   (c) explaining in the Basis for Conclusions on the revised *Conceptual Framework* that the notion of prudence cannot be used by preparers to override the requirements in IFRS Standards.

Structure of paper

3. This paper is structured as follows:

   (a) background (paragraphs 4–7);

   (b) summary of feedback (paragraphs 8–20);

   (c) staff analysis (paragraphs 21–47):

      (i) should the *Conceptual Framework* include a reference to prudence? (paragraphs 21–24);

      (ii) cautious prudence or asymmetric prudence? (paragraphs 25–32); and

      (iii) additional clarifications to address respondents' concerns (paragraphs 33–47).

Background

4. The *Framework for the Preparation and Presentation of Financial Statements* (the 'pre-2010 *Framework*') stated that financial statements should be neutral, or free from bias, and discussed the need for preparers to exercise prudence when preparing financial statements:

> 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 judgements needed in making the estimates required under conditions 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 statement would not be neutral and therefore, not have the quality of reliability[1].

5. In developing the existing version of Chapter 3—*Qualitative characteristics of useful financial information*, (corresponding to Chapter 2 of the Exposure Draft), issued in 2010, the Board removed the reference to prudence, because it was concerned that the term could be interpreted to be inconsistent with neutrality.

6. However, the removal of the term led to confusion, with some constituents saying that the term's removal suggested that financial information prepared using IFRS Standards could be imprudent. Many respondents to the Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* urged the Board to reinstate prudence. In response to this feedback, in the Exposure Draft , the Board proposed to reintroduce an explicit reference to the notion of prudence (described as caution when making judgements under conditions of uncertainty):

> 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 income are not understated. Equally, the exercise of prudence does not allow for the understatement of assets and income or the overstatement of liabilities and expenses, because such mis-statements can lead to the overstatements of income or the understatement of expenses in future periods.

7. In the Basis for Conclusions, the Board distinguished between two types of prudence:

   (a) 'cautious prudence'—a need to be cautious when making judgements under conditions of uncertainty, but without needing to be more cautious in judgements relating to gains and assets than those relating to losses and liabilities . It is in this sense that the Board proposed to reintroduce prudence in the *Conceptual Framework.*

[1] In 2010 the label 'faithful representation' was applied to the qualitative characteristic previously labelled 'reliability'.

(b) 'asymmetric prudence'—a need for systematic asymmetry: losses are recognised at an earlier stage than gains are. The Exposure Draft did not identify asymmetric prudence as a necessary characteristic of useful financial information. However, it explained that accounting policies that treat gains differently from losses can be selected in accordance with the proposals in the Exposure Draft if:

(i) they are selected in a manner that is not intended to increase the probability that financial information will be received favourably or unfavourably by users of financial statements (ie neutral accounting policies are selected); and

(ii) their selection is intended to result in relevant information that faithfully represents what it purports to represent.

Summary of feedback

8. The invitation to comment on the Exposure Draft asked respondents whether they support the proposal to reintroduce an explicit reference to the notion of prudence and to state that prudence is important for achieving neutrality. About three-quarters of respondents commented on the question.

Support for cautious prudence

9. Many respondents, representing a broad cross-section of geographical regions and types of respondent, supported reintroduction of prudence described as caution under conditions of uncertainty.

10. However, for some, especially from Europe, support was conditional. These respondents agreed that cautious prudence is important for the application of neutral accounting policies; however, they said the Board should also explain how prudence should be applied in the selection of accounting policies. They noted the discussion on this topic in the Basis for Conclusions (see Appendix B) and agreed with the statement in paragraph BC2.14 that 'accounting policies that treat gains and losses asymmetrically could be selected in accordance with the proposals in the Exposure Draft if their selection is intended to result in relevant information that faithfully

represents what it purports to represent'. These respondents suggested that the *Conceptual Framework* should acknowledge such possible asymmetry in selecting accounting policies for gains and losses (assets and liabilities) and include some of the discussion that is currently included in the Basis for Conclusions.

11. Respondents' views on who could choose such asymmetric accounting policies differed:

    (a) most said that only the Board, when developing a particular Standard, could select accounting policies that treat gains and losses (assets and liabilities) asymmetrically; while

    (b) a few respondents suggested that this should also be applicable to preparers, including those who select accounting policies based on the *Conceptual Framework* when no Standard or Interpretation specifically applies to a transaction.

12. A few respondents suggested that the possibility of selecting asymmetric accounting policies could be discussed in other relevant chapters of the *Conceptual Framework,* such as in Chapter 5—*Recognition and derecognition* and Chapter 6—*Measurement*, instead of in Chapter 2.

13. A few respondents expressed the view that by acknowledging and explaining the possibility of selecting asymmetric accounting policies, the Board would contribute to a more consistent application of the concept. A standard-setter stated that it would also help auditors when assessing the application of prudence, and so would enhance the auditability of financial statements.

14. On the other hand, a few respondents found the discussion of asymmetric prudence and possible asymmetry in selecting accounting policies in the Basis for Conclusions to be confusing and said it could create uncertainty about the role of prudence in standard-setting.

Proposal by some respondents to introduce asymmetric prudence

15. Some respondents, predominantly from Europe, disagreed with the reintroduction of the notion of prudence explained as caution. Instead, they suggested including

asymmetric prudence in the *Conceptual Framework*. The reasons for their proposal are provided in paragraph 26.

16. These respondents suggested different ways of introducing asymmetric prudence into the *Conceptual Framework*:

    (a) asymmetric prudence that would require more persuasive evidence to support the recognition of gains (or assets) than of losses (or liabilities);

    (b) asymmetric prudence that would require the selection of measurement bases that include losses at an earlier stage than gains (ie historical cost);

    (c) using the pre-2010 version of prudence, that some believe required asymmetry and gave prudence the same prominence as neutrality; and

    (d) introduction of asymmetric prudence for the Board in addition to cautious prudence for preparers.

Opponents of reintroduction of prudence

17. In contrast, some respondents, including many from Australia and New Zealand, objected to the reintroduction of any notion of prudence. They argued that the reintroduction is likely to be misinterpreted as leading to bias in recognition and/or measurement and could result in over-provisioning and profit-smoothing. A few respondents explicitly supported the alternative view of Patrick Finnegan (see Appendix A).

18. Some opponents commented that if the notion of prudence is reintroduced, the *Conceptual Framework* should be clear that asymmetric prudence was rejected and why.

Interaction with neutrality

19. The respondents' views on the interaction between prudence and neutrality differed. Some respondents, mostly those who supported reintroduction of prudence as proposed in the Exposure Draft, agreed with the statement that prudence is important in achieving neutrality. However, a few respondents commented on how the

Conceptual Framework could clarify the link between prudence, asymmetry and neutrality:

(a) it could be helpful to separate the notions of prudence and asymmetry, for example by not describing asymmetry as asymmetric prudence;

(b) using ‘unbiased’ instead of ‘neutral’ could avoid misunderstandings;

(c) the *Conceptual Framework* should explain that prudence is not necessarily inconsistent with neutrality, but should not state that prudence ‘supports’ neutrality;

(d) neutrality should be identified as a starting-point in standard-setting. If there is a valid reason for a Standard to incorporate asymmetry, the Board would have to explain its choice in the Basis for Conclusions.[2]

20. Some of the respondents, who suggested introducing asymmetric prudence into the *Conceptual Framework*, expressed a view that prudence does not help achieve neutrality and the statement in the Exposure Draft that neutrality is supported by the exercise of prudence is misleading.

Staff analysis

Should the Conceptual Framework *include a reference to prudence?*

Not reintroducing prudence in any form

21. Not reintroducing prudence in any form would respond to concerns of those who think that a reference to prudence is likely to be misinterpreted as leading to bias in recognition and/or measurement and could provide opportunities of earnings management. It would also mean that the related section of the *Conceptual Framework* would remain converged with the FASB’s Concepts Statement No 8 *Conceptual Framework for Financial Reporting—Chapter 3,* Qualitative Characteristics of Useful Financial Information.

[2] There was some inconsistency in the use of the term ‘neutrality’ in the comment letters. Some respondents, when talking about the selection of accounting policies, seemed to imply that neutral accounting policies should be the same for gains and losses, while the description of neutrality in the *Conceptual Framework* is different (see paragraphs 39–40).

22. However, the 2010 decision to remove the reference to prudence has clearly generated significant debate. Feedback on both the Discussion Paper and the Exposure Draft largely favoured reintroducing the reference to prudence. Consequently, the staff suggest the Board keep the reference to prudence in the revised *Conceptual Framework* and seek to address the concerns of this group of respondents in another way (see paragraphs 33–47).

Not using the term 'prudence'

23. The Board could also consider another suggestion, made by some members of Accounting Standards Advisory Forum at its April 2016 meeting and a few respondents to the Exposure Draft, not to use the term 'prudence'. The *Conceptual Framework* would describe what the notion encompasses in terms of 'caution', 'care', etc. but avoid using the term 'prudence'. While it may help avoid some misinterpretations associated with the term 'prudence', it will not necessarily help achieve a consistent understanding and application of the notion:

    (a) when the term 'stewardship' was removed and replaced with the description of what it encapsulates, it was understood as the removal of the notion from the *Conceptual Framework*, rather than a clarification, and the description was not sufficient to make the Board's intentions clear.

    (b) a newly chosen term, for example 'caution', may lead to similar misinterpretations. IFRS Standards are required for public companies in nearly 120 countries, and it is difficult to know without additional research whether the chosen term would not have any more conservative / pessimistic associations than the Board intends to convey.

    (c) not using the word 'prudence' may not satisfy those who want prudence to be reintroduced.

    (d) 'prudence' is used as a legal requirement for financial statements in some jurisdictions, for example, in the EU.

24. For these reasons, the staff do not recommend replacing 'prudence' with another term.

Cautious prudence or asymmetric prudence?

25. In the Exposure Draft the Board proposed to reintroduce prudence in the sense of cautious prudence, ie a need to be cautious when making judgements under conditions of uncertainty, but without needing to be more cautious in judgements relating to gains and assets than in those relating to losses and liabilities. As noted in paragraph 9, many respondents supported this proposal.

26. However, some respondents proposed introducing asymmetric prudence rather than cautious prudence to Chapter 2. They argued that:

    (a) the treatment of cautious prudence in the *Conceptual Framework* serves no useful purpose that is not already served by the concept of neutrality;

    (b) the *Conceptual Framework* should use the term ‘prudence’ in its traditional meaning which is, in their view, the asymmetric recognition of gains (or assets) and losses (or liabilities)[3];

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

    (d) asymmetric prudence is inherent in many IFRS Standards and the *Conceptual Framework* should acknowledge this fact so that asymmetric prudence can be applied consistently when setting Standards;

    (e) in many jurisdictions where IFRS Standards are currently implemented, prudence (interpreted by the respondents as asymmetric prudence) is already a legal requirement for financial statements presented by publicly-listed entities;

    (f) returns to investors should be paid on a prudent (interpreted by the respondents as asymmetrically prudent) basis. Otherwise there is danger that today’s shareholders could benefit at the expense of future shareholders;

    (g) management remuneration should be paid on a prudent (interpreted by the respondents as asymmetrically prudent) basis to reduce management’s opportunism and encourage long-term growth.

[3] In academic literature, prudence in this sense is often referred to as conservatism.

27. However, the staff believe that the *Conceptual Framework* should continue to exclude asymmetric prudence—ie a systematic need for asymmetry in recognition/measurement—because:

    (a) A systematic requirement for asymmetry in recognition/measurement of assets and liabilities or gains and losses could sometimes conflict with the need for financial information to be relevant and to provide a faithful representation.

    (b) It could be misinterpreted by some as an opportunity to introduce bias, which could:

        (i) lead to earnings management, for example, through creating excessive expense accruals in one period and inflating earnings in future periods.

        (ii) lead to greater subjectivity as the understanding to which degree bias should be applied may differ. That would make financial statements less comparable and understandable.

28. The staff also note that while IFRS financial reports may be used as inputs in determining dividends and management remuneration, the IFRS financial statements are only one of the factors that need to be considered:

    (a) An entity's ability to 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).

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

29. While some investors urge the Board to introduce asymmetric prudence, some agree with the explanation of prudence as the exercise of caution and strongly argue for financial statements with no systematic bias. The staff note that while rejecting systematic asymmetry in recognition/measurement, when developing particular

Standards, the Board considers what information is relevant to investors in that particular case, including whether they are more interested in downside risk than upside potential (also see paragraphs 35–36).

30. In addition, the respondents' suggested ways of introducing asymmetric prudence into the *Conceptual Framework* confirm that there is no single understanding of the notion 'asymmetric prudence' and how it should be applied (see paragraph 16). Consequently, introduction of asymmetric prudence will not necessarily lead to a universal understanding of prudence and may lead to increased subjectivity and loss of comparability.

31. For the reasons discussed above, the staff recommend that the revised *Conceptual Framework* should include a reference to prudence described as 'the exercise of caution when making judgements under conditions of uncertainty'.

32. Paragraphs 33–47 discuss whether the Board could make further clarifications to aid consistent application of this notion.

Question 1—Cautious prudence or asymmetric prudence
Do you agree that the revised *Conceptual Framework* should include a reference to prudence described as the exercise of caution when making judgements under conditions of uncertainty, as proposed in the Exposure Draft?

Additional clarifications to address respondents' concerns

33. Respondents' concerns centred on two main themes:

    (a) from supporters of asymmetric prudence—that losses (or liabilities) should be recognised at an earlier stage than gains (or assets); and

    (b) from opponents of introducing prudence in any form—that the term 'prudence' will be misunderstood as leading to bias and misused for earnings management.

34. Paragraphs 35–47 propose some clarifications that could help to alleviate these concerns.

Possibility of asymmetric policies

35. As noted in paragraph 29, when developing Standards, the Board inevitably considers the needs of users. Those considerations include whether in that particular instance users would find it more useful to:

    (a) recognise losses earlier that gains; or

    (b) select a measurement basis that allows the recognition of unrealised losses but does not allow the recognition of unrealised gains.

36. For example, paragraphs BC206–BC207 of the Basis of Conclusions on IFRS 15 *Revenue* explain that the decision to recognise variable consideration only when it is 'highly probable' was made because users of financial statements indicated that revenue is more relevant if it is not expected to be subject to significant future reversals.

37. The Basis for Conclusions on the Exposure Draft acknowledged the possibility of selecting accounting policies that treat gains and losses asymmetrically (see Appendix B). For some respondents, including some users, this acknowledgement was the condition for supporting the introduction of prudence into the *Conceptual Framework*. However, they said that this acknowledgement was not visible enough and suggested including it into the text of the *Conceptual Framework* itself.

38. The staff think that including such an acknowledgement in the *Conceptual Framework* would be helpful because it would make it clear that such policies have to result in relevant information that faithfully represents what it purports to represent—it will still have to have the fundamental qualitative characteristics of useful financial information.

39. In addition, discussing the selection of asymmetric accounting policies could help to clarify that, contrary to concerns expressed by some respondents, asymmetric accounting policies, as described in paragraph 38, are consistent with neutrality. While some respondents associate neutrality with symmetry in selecting accounting policies for gains (or assets) and losses (or liabilities), the existing *Conceptual Framework* describes a neutral depiction as:

> 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.[4]

40. Paragraph BC2.12 of the Basis for Conclusions on the Exposure Draft further explains that the selection of neutral accounting policies means selecting accounting policies in a manner that is not intended to increase the probability that financial information will be received favourably or unfavourably by users.

41. Based on this explanation, a few respondents to the Exposure Draft suggested replacing the term 'neutral' with the term 'unbiased'. However, the staff think that 'unbiased' may also imply the selection of 'symmetrical' accounting policies, so it would not necessarily help achieve clarity.

42. As noted in paragraph 12, a few respondents to the Exposure Draft suggested that the selection of asymmetric accounting policies could be discussed in other relevant chapters of the *Conceptual Framework* (Chapter 5 and Chapter 6) instead of in Chapter 2. However, we consider this discussion is best placed in Chapter 2 because it helps clarify what we mean by the term 'neutrality'.

43. Consequently, the staff propose adding the following wording to Chapter 2 of the revised *Conceptual Framework*:

> Neutrality does not preclude selection of accounting policies that treat gains (or assets) and losses (or liabilities) asymmetrically if their selection is intended to result in relevant information that faithfully represents what it purports to represent.

Question 2—Acknowledging the possibility of asymmetry
Do you agree that the *Conceptual Framework* should include an acknowledgement that accounting policies that treat gains (or assets) and losses (or liabilities) asymmetrically could be selected if their selection is intended to result in relevant information that faithfully represents what it purports to represent?

[4] See paragraph QC14 of the existing *Conceptual Framework* (paragraph 2.17 of the Exposure Draft).

Prudence in the Conceptual Framework *vs requirements in Standards*

44. Some opponents of the reintroduction of prudence expressed concern that the notion of prudence could be misused by preparers to override a Standard if, in their opinion, it does not result in 'prudent' financial statements.

45. The staff note that the concepts in the *Conceptual Framework* can be directly applied by preparers in developing an accounting policy only in accordance with paragraph 11 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* when no Standard applies to a particular transaction or event.

46. Consequently, if a transaction or event is covered by an existing Standard, preparers will not be able to override the requirements of that Standard if they think that they are imprudent because the *Conceptual Framework* itself does not override any of the requirements in the Standards[5]. This status of the *Conceptual Framework* was confirmed at the April 2016 Board meeting when the Board discussed the purpose and status of the *Conceptual Framework.*

47. Including an explanation in the Basis for Conclusions that the notion of prudence cannot be used by preparers to override the requirements in the Standards would help to address some of the concerns raised by respondents to the Exposure Draft.

Question 3—Prudence in the *Conceptual Framework* vs Standards
Do you agree that the Basis for Conclusions on the revised *Conceptual Framework* should explain that the notion of prudence cannot be used by preparers to override the requirements in the Standards?

[5] Paragraphs 19–24 of IAS 1 *Presentation of Financial Statements* allow an entity to depart from the requirement in the *Conceptual Framework* only in the extremely rare circumstances in which management concludes that compliance with a requirement in an IFRS would be so misleading that it would conflict with the objective of financial statements.

Appendix A—Extract from the alternative view of Patrick Finnegan

Prudence

AV16 Mr Finnegan disagrees with the decision to reintroduce an explicit reference to the notion of prudence in the *Conceptual Framework* to support the meaning of neutrality, ie a lack of bias in the selection or presentation of financial information. He believes that financial information possessing the characteristic of neutrality is already free from bias. Mr Finnegan thinks that if prudence is included in the *Conceptual Framework* or any Standard, it would introduce bias and would create confusion in the minds of many preparers about whether or how it should be applied. Even though the Exposure Draft attempts to make it clear that prudence is consistent with neutrality, Mr Finnegan disagrees that prudence (the exercise of caution) is consistent with neutrality. He believes the use of that term within the *Conceptual Framework* could result in:

(a) Standards designed to produce weighted outcomes.

(b) preparers being cautious by understating assets and overstating liabilities or being cautious in communicating bad news and hence overstating assets and understating liabilities. Such actions have the potential to confuse investors and lower their confidence in financial reporting.

Appendix B—Extract from the Basis for Conclusions on the Exposure Draft

Asymmetric prudence

BC2.11 Some argue that asymmetric prudence is a necessary characteristic of useful financial information and that prudence cannot be consistent with neutrality. The IASB disagrees with this view. However, the IASB also thinks that not all asymmetry is inconsistent with neutrality.

BC2.12 The selection of neutral accounting policies means selecting accounting policies in a manner that is not intended to increase the probability that financial information will be received favourably or unfavourably by users.

BC2.13 The selection of neutral accounting policies, contrary to fears sometimes expressed:

(a) does not require an entity to recognise the value of the entire entity in the statement of financial position. Paragraph 1.7 of the Exposure Draft states that general purpose financial reports are not designed to show the value of a reporting entity.[6]

(b) does not require the measurement of all assets and liabilities at a current value. Indeed, the proposals in Chapter 6 of the Exposure Draft would not lead to such a requirement.

(c) does not prohibit impairment tests on assets measured at historical cost. Measurement at historical cost (including an impairment test) is consistent with neutrality if that measurement basis is selected without bias; in other words, without slanting, weighting, emphasising, de-emphasising or otherwise manipulating information to increase the probability that it will be received favourably or unfavourably by users.

(d) does not require the recognition of all assets and liabilities. Chapter 5 of the Exposure Draft discusses recognition criteria for assets and liabilities.

BC2.14 Hence, accounting policies that treat gains and losses asymmetrically could be selected in accordance with the proposals in the Exposure Draft if their selection is intended to result in relevant information that faithfully represents what it purports to represent. Such an approach is reflected in many existing Standards, for example IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* requires different recognition thresholds for contingent liabilities and contingent assets. However, the IASB thinks that the *Conceptual Framework* should not identify asymmetric prudence as a necessary characteristic of useful financial information. In particular, the IASB rejects the following approaches that some argue would follow from a requirement to apply asymmetric prudence in all circumstances:

(a) prohibiting the recognition of all unrealised gains. In some circumstances, for example, the measurement of many financial instruments, the recognition of unrealised gains is necessary to provide relevant information to users of financial reports.

(b) prohibiting the recognition of unrealised gains not supported by observable market prices. In some circumstances, measuring an asset or a liability at a current value (which may require the recognition of unrealised gains) provides relevant information to users of financial reports even if the current value must be estimated.

(c) permitting an entity to measure an asset at an amount that is less than an unbiased estimate using the measurement basis selected for that asset or to measure a liability at more than such an amount. Such an approach cannot result in relevant information and cannot provide a faithful representation.

BC2.15 In addition, the IASB notes that if it were to introduce asymmetric prudence, it would need to consider how much bias is appropriate.

6 Paragraph OB7 of the existing *Conceptual Framework* makes the same statement.