PRUDENCE IS MISSING

A paper prepared by the UK Shareholders' Association

Introduction

The UK used to have four fundamental accounting concepts of which "prudence" was one. Prudence was the ultimate protection for investors, particularly private investors such as those the UK Shareholders' Association (UKSA) represents. They by definition lack the resources of institutional investors to unearth what may be the imprudent assumptions encountered in company accounts. But in UKSA's opinion, prudence is no longer the underlying principle it once was.

The prudence principle has progressively been stripped away by the introduction of accounting standards which leave auditors with no argument to stand on when they question a valuation. The formal concept of prudence is not present in the "Conceptual Framework" underlying current accounting standards published by the International Accounting Standards Board (IASB) and this enables company financial officers to pick their own choice of asset values from an approved range, even if the auditors judge that choice to be imprudent.

Standards are essential, but they need to be grounded in clear principles including prudence. Moreover, they must allow scope for professional judgment to ensure they satisfy the over-arching legal requirement stated in the UK Companies Act that accounts must provide a "true and fair view". In recent months, there has been a growing challenge to the IASB's assertion that, despite there being no mention of prudence in its Conceptual Framework, that principle nevertheless does underlie its International Financial Reporting Standards (IFRS).

UKSA, whose members are in the main long term investors, joins other long term investors in asserting that the IASB is wrong. The absence of this principle has proved extremely damaging to all long term investors, because it has meant that accounting standards can no longer be relied upon to ensure a "true and fair view" of a company's capital position.

First Defence

The IASB, which sets IFRS, has responded to these criticisms in two main ways. First, the chairman of the IASB, Hans Hoogervorst, has argued that, even though the concept of prudence has been removed from its Conceptual Framework, *"…it is still very much engrained in our standards"*.[1] The IASB reinforced this view in December 2012 stating *"…despite its removal from the Framework, the basic tenets of the concept of prudence remain intact…"* [2]

UKSA dismisses this argument. First, because, if there is no direct link between the Conceptual Framework and the standards themselves, the Framework would appear to be pointless. However, there are contradictory statements on this matter from the IASB itself. Hoogervorst, for instance, argued in a speech to the LSE that, *"The Conceptual Framework is the theoretical foundation of our standards."*[3] So, if the Framework is the foundation of its standards and this ignores prudence, how can it be that the individual standards are still based on prudence? Either prudence is the basic attitude, or it is not, but the IASB's desire to have it both ways cannot be sustained.

---

[1] Speech to the FEE conference 18 Sept 2012.
[2] Memorandum submitted to the Panel on tax, auditing and accounting set up by the Parliamentary Commission on Banking Standards. Para 13.
[3] Lecture at the London School of Economics 6 November 2012

The IASB's position is further weakened by the absence of prudence not only from the Conceptual Framework but from the individual standards too. Perhaps the most prominent example is that of loan loss provisioning. Indeed, the IASB has now agreed that the standard which required "impairments" only to be recognised on what it calls the "incurred-loss impairment model" is inadequate. *"We think that this criticism was partially justified"*[4]. So a new Exposure Draft (ED) on the impairment of financial assets has been published, widening the definition of assets that can be deemed to be impaired – but the ED specifically argues that "conservatism" (the American word for prudence) should *not* apply.[5]

Second Defence

A second argument used by the IASB to respond to criticisms that IFRS are no longer prudent, is that IAS 1 has a built-in an over-ride. However, this so-called "over-ride" only allows individual standards to be over-ridden if a standard would produce a result which "would conflict with the objective of financial statements set out in the Framework".[6] That objective is "to provide financial information…that is useful to existing and potential investors, lenders and other creditors…,"[7] but, of course, as the Framework does not provide for prudence, this potential over-ride cannot compensate. Nor does the Framework include a "true and fair view" as its objective.

The UK Financial Reporting Council (FRC) has recognised this inconsistency but seems, until recently, to have gone along with it. *"The concept of prudence has evolved from the way it was applied in UK GAAP prior to the adoption of FRS 18 - greater emphasis on neutrality reflects a growing concern about the smoothing of profits. Similar considerations have also driven changes to the IFRS Conceptual Framework, to replace prudence with neutrality. However, in practice the concept of prudence continues to underlie the preparation of accounts under both UK GAAP and IFRS."*[8] The FRC is however perhaps now changing its stance, in that it has joined with the European Financial Reporting Group (EFRAG) and other European standard setters in a recent document which states, *"It remains open to question, however, whether the Framework should specifically refer to prudence and precisely what prudence means."*[9]

Action Required

UKSA members, indeed all investors, need accounts which are reliable and prudent. UKSA therefore calls on the IASB to rethink its position, rectify the mistakes that have been made and ensure the place of prudence in all future standards.

UKSA will then be able to fully support the essential standard setting process.

RAC/EC 23.4.13

[4] Memorandum as 2 above. Para 16.
[5] IASB Exposure Draft- March 2013 "Financial instruments: Expected credit losses". Para BC18.
[6] IAS 1 Para 23
[7] IASB:Conceptual Framework: Para OB1
[8] FRC paper of July 2011, signed on behalf of the Accounting Standards Board by Roger Marshall and on behalf of the Auditing Practices Board by Richard Fleck.
[9] "Getting a better Framework: our strategy". EFRAG and others January 2013