Association of British Insurers

European Financial Reporting Advisory Group

Getting a Better Framework: PRUDENCE

Introduction

1. The ABI is pleased to respond to the European Financial Reporting Advisory Group's (EFRAG) consultation on the role of prudence in financial reporting. We welcome the EFRAG's initiative in promoting debate on this important aspect of the financial reporting, particularly in the context of the IASB's conceptual framework project.

2. The ABI is the voice of insurance, representing the general insurance, investment and long-term savings industry. It was formed in 1985 and today has over 300 members, accounting for some 90% of premiums in the UK.

3. Our views represent in particular the perspectives of our members both as insurers and as institutional investors with some £1.6 trillion of funds under management. These include both equity and fixed interest securities, listed and unlisted, of entities with financial reporting obligations located, denominated or traded in many different countries worldwide. As investors, our members therefore make use of company financial reporting to inform both their investment decisions and the exercise of their rights and responsibilities in respect of the companies they invest in. As insurers, our members report to their shareholders and other capital providers.

General Comments

4. Long term shareholders have a strong interest in a system of financial reporting that is predicated on accounts being prepared on a prudent basis, providing them with a true and fair view of the state of affairs of the business. This forms the basis on which views can properly be formed about the directors' stewardship of shareholder and creditor capital, the going concern status of the business and the capital properly available for distribution. It also helps promotes stable and sustainable economic growth.

5. As applied in accounting, "prudence" is a fundamental qualitative notion for guiding issuers (and auditors) when exercising (or assessing) aspects of accounting that require judgement, or where adherence to the standards might otherwise result in outcomes that are misleading or in some way erroneous. It is a predisposition, in the face of uncertainty, to err on the side of later rather than earlier recognition of revenues and assets, earlier rather than later recognition of costs (incl. impairments) and liabilities and a clear distinction being made between realised (ergo distributable) and unrealised profits.

6. Prudence is a disciplining characteristic of judgments that acts as a counterweight to the incentives and optimism bias that can manifest themselves amongst preparers of accounts. It also provides traction to auditors in assessing and challenging the appropriateness of accounting outcomes (the substance) as opposed to the process by which they were achieved (the form).

7. The importance attached by long-term shareholders to the essential role that prudence has to play in fair value and other aspects of accounting, is not unrelated to the importance attached to it by prudential regulators in the context of the calculation of banks' capital and their estimates of expected losses and calculation of risk weights.

8. In both contexts, the need for prudence to be exercised in the preparation of accounts is not just a matter of shareholder preference, but it is a matter of EU company law (and, similarly, of UK Company Law). Regrettably, the International Accounting Standards Board's (IASB) convergence strategy with US GAAP has resulted in an increased emphasis on neutrality. The legal basis and scope of the accounting framework in the US (where it is part of Securities Law, not company law) is different from that in the EU. Given the EU is key adopter of IFRS (unlike the US) we consider it to be imperative that "prudence" is restored as a central, guiding principle in the development and reform of IFRS accounting standards and the preparation of statutory accounts and their auditing.

9. Prudence is not in our view, and contrary to a number of previous IASB pronouncements, incompatible with fair value accounting. Accounting numbers range from objective numerical facts, typically reflecting transaction amounts on an historical cost basis, to point estimates representing an underlying known or unknown probability distribution of possible realities or outcomes. Uncertainty in valuations of assets and in respect of estimates of future income and cash flows is negative for investors and markets and the impact of such uncertainty is in turn reflected in market prices and in rates of return required by investors. In the likely absence of objective evidence about the probability-weighted distribution of future cash-flows where averages or central estimates should in turn be appropriately discounted for risk, the exercise of prudent judgment will enhance the reliability and hence the usefulness of financial statements for investment and stewardship decision making.

10. In addition, in the absence of, amongst other things, prudence as a fundamental characteristic of IFRS accounting, accounts prepared in accordance with IFRS may not, as a matter of law, ensure a true and fair view, as required in EU's Fourth and Seventh Company Law Directives. This broader question in relation to IFRS's consistency with the accounting framework established in law has been the subject of a Legal Opinion from a leading QC in the UK confirming these concerns.

11. As a final matter, we would note that understating or obscuring risks is not compatible with prudence, nor is the building up of hidden reserves or of any

provisions that are larger than is necessary. Such practices are clearly imprudent and would conflict with the true and fair requirement.

12. In light of the above, it is our position that prudence has an important role to play in accounting standards setting, the application of accounting methodologies, such as fair value accounting, and in the Conceptual Framework that sits behind them, as well as in the auditing of statutory accounts prepared using IFRS standards. We support the reinstatement of prudence as a fundamental concept in the IASB's Conceptual Framework underpinning its development of IFRSs.

ANNEX

Questions for Consultation

(i) Is there a role for prudence in the development of accounting standards? If so, should it (i) focus on recognition and measurement criteria, and the timing of recognition of gains and losses; or (ii) be described as the general exercise of caution?

Yes, and both. However, we note that prudence is of paramount importance to 'recognition', both in respect of assets and liabilities, and perhaps less so for 'measurement', where 'neutrality' is a reasonable aim.

(ii) Does the current Framework adequately reflect the essence of prudence, or do you share the tentative view that its role should be explicitly considered? If so, how would you characterise the level of caution you believe should be observed? References to various views in the bulletin would be helpful.

Yes, prudence needs to be considered explicitly as a fundamental accounting principle.

(iii) Are there requirements in current IFRS not mentioned in this Bulletin which fail to reflect prudence? Are there requirements in current IFRS which in your view are overly prudent?

(iv) Do you have any other comments on this Bulletin?

No.

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