EFRAG STAFF PAPER FOR PUBLIC MEETING

Assessing prudence in the context of endorsement

Objective

1 The objective of this paper is to discuss how to incorporate and apply the notion of prudence in EFRAG's assessment of the new accounting standards.

2 In the Maystadt report, it was recommended that EFRAG could be asked to analyse more thoroughly the compliance with criteria regarding prudence and respect for the public good.

3 The request for endorsement of IFRS 9 from the European Commission also mentions specifically the need for an assessment in the light of the principle of prudence.

Prudence in the IAS Regulation

4 Prudence is not explicitly mentioned in Regulation 1606/2002. The Regulation mentions that to adopt an international accounting standard it is necessary firstly to meet the basic requirement of the Accounting Directives, that is to say that its application results in a true and fair view of the financial position and performance of an enterprise, without implying a strict conformity with each and every provision of the Directives; secondly, that it is conducive to the European public good and lastly, that it meets basic criteria as to the quality of information required for financial statements to be useful to users.

5 Article 6 of the Directive is meant to provide the general principles to meet the objective that the financial statements shall give a true and fair view. Article 6 lists the prudent basis of accounting on the same level with principles such as the going concern basis (6.1(a)), the consistency of application of accounting policies (6.1(b)), the accrual basis of accounting (6.1(d)), the substance over form principle (6.1(h)) and the materiality principle (6.1(j)). It can be argued that all these are embedded in the European Union notion of 'true and fair view', at least to some extent, and cannot be ignored – which does not mean that each of these principles must be strictly complied with in all instances and that there cannot be exceptions or exemptions.

6 While the Regulation does not refer to the F*ramework for the Preparation and Presentation of Financial Statements,* EFRAG staff also notes that it draws the endorsement criteria of *understandability, relevance*, *reliability* and *comparability* from the qualitative characteristics in the version of the Framework applicable at that time. That version also mentioned prudence, which reinforces the argument that prudence plays a role in the context of endorsement under the Regulation.

7 The principle of prudence as contained in the new Accounting Directive is set out in Article 6(1)(c) in the following terms:

Recognition and measurement shall be on a prudent basis, and in particular:

(a) *only profits made at the balance sheet date may be recognised,*

(b) *all liabilities arising in the course of the financial year concerned or in a previous financial year shall be recognised, even if such liabilities become apparent only between the balance sheet date and the date on which the balance sheet is drawn up,*

(c) *all negative value adjustments shall be recognised, whether the result of the financial year is a profit or loss.*

8 Article 6(1)(c) states some important specifications, but does not provide a full definition. The word "in particular" implies that only a part of the practical implications of prudence is indicated there. The different ways in which the prudence principle plays a role in the Directive could be grouped under three basic headings:

(a) Prudence reflected in the recognition and valuation of assets and liabilities, for instance by restricting the conditions to recognise an intangible asset or requiring to adjust the carrying amounts to their realisable value;

(b) Prudence in obtaining an adequate assessment of situations of particular risk;

(c) Prudence in dealing with profits.

9 The prior Directive employed similar words to refer to the prudent basis of accounting.

How prudence can be defined

10 In April 2013 EFRAG and the national Standard Setters of France, Germany, Italy and United Kingdom published a bulletin on prudence in the *Getting a Better Framework* series. The bulletin recalled the distinction between conditional conservatism - that results in asymmetric timeliness in the recognition of good and bad news (the latter recognised earlier) – and unconditional conservatism, which results in systematic understatement of net assets. The bulletin noted that there is a general agreement on the usefulness of conditional conservatism, while unconditional conservatism is more contentious.

11 The partners expressed a tentative view that it was useful to consider explicitly the role of prudence in making decisions about recognition, measurement, presentation and disclosures.

12 In the *Framework for the Preparation and Presentation of Financial Statements* ('pre-2010 Framework') prudence was characterised as *the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated.*

13 However it was added that the use of prudence should not result in a loss of reliability or neutrality and it should not result in the deliberate overstatement of expenses and understatement of income.

14 The IASB is considering the reintroduction of a reference to prudence in the Conceptual Framework and characterise it as exercise of caution when making judgements under conditions of uncertainty. This articulation of prudence seems to mostly refer to the measurement of assets and liabilities, although it may be applicable also to recognition - for instance, assessing the probability of future benefits when considering recognition of an intangible asset, or assessing the existence of a present obligation in the event of a legal proceeding.

15 There is a different interpretation that prudence has another important role, unrecorded in the current Conceptual Framework, that under some circumstances may require asymmetry in recording gains and losses[1]. This interpretation of prudence underlies the higher probability threshold for the recognition of contingent assets compared to contingent liabilities, and justifies why upward revaluation adjustments are not recognised, for example for inventory.

16 This interpretation results in recognising losses always when incurred, and some gains only when they are made. In this context, a gain is deemed to be made when either of the following applies:

(a) The asset is held for trading in a ‘price change’ business model (which usually would imply the existence of a liquid market); or

(b) Control of the asset has been transferred in a transaction with a party outside the reporting entity. In this case, the recovery of the increase in value over amortised cost is not subject to any uncertainty.

Considering prudence in the endorsement process

17 EFRAG staff believes that applying the first notion of prudence - exercise of caution in conditions of uncertainty - in the endorsement process involves assessing if a standard appropriately considers the impact of uncertainty on:

(a) *the existence of an asset or a liability*;

(b) the *selection of the measurement approach*; and

(c) the *application of the measurement*.

18 This assessment is made by the IASB in developing a standard.

19 EFRAG staff believes that applying the second notion of prudence – which may require asymmetry in recognition – involves assessing, in addition, if a standard requires:

(a) applying a higher probability threshold when recognising an asset than a liability; and/or

(b) not recognising gains under certain conditions, while always recognising losses.

20 This assessment is made by the IASB in developing a standard. It may also be considered by an entity in applying the standard.

21 EFRAG staff notes that prudence is an aspect of relevance, and must be assessed for endorsement purposes in that context. The assessment is made on an absolute

[1] FRC Paper *The reporting of income and expenses and the choice of measurement basis* presented at the Accounting Standards Advisory Forum, June 2014.

basis – that is, it does not consider if the requirements under assessment are more or less prudent of any existing requirements.

Question to EFRAG Board

22 Do you agree that prudence encompasses both the exercise of a degree of caution in making judgments under conditions of uncertainty; and the notion that it may be appropriate, under some circumstances, to have asymmetry in recognition of gains and losses?