THE REVIVAL OF PRUDENCE IN ACCOUNTING – TRUTH OR ILLUSION (AFTER THE LONG-LASTING EROSION)

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Abstract: Over the past decade and a half profound changes have occurred in financial reporting in Europe and elsewhere, discussed in the present research, as well as the antagonism of views that have been raised in the debate focused on the benefits of the process. The political decision on the IAS adoption by the EU Member States from January 1st, 2005 was a challenge for institutional and professional organizations, national and supranational bodies of authority, and many people at different levels of corporate governance.
The article provides views, arguments and conclusions that are result of the author's research prompted by the International Accounting Standards Board (IASB) decision to revise substantial parts of the Conceptual Framework for Financial Reporting (CF) and remove (in September 2010) "prudence" in favor of "neutrality" as a qualitative characteristic. On the basis of the literary review, the article focuses on a wide range of well-founded reasoning from an academic and research viewpoint. The author's aim is not to discuss the role of the CF, or its objectives, but to contribute to the current debate on a complicated and highly controversial issue, raised in the Discussion Paper[46] (DP), followed by the Exposure Draft (ED), published in January 2014 and May 2015, containing proposals for a revised CF. The analysis is primarily directed at justifying the necessity of reintroducing "prudence" into the CF, and that is the primary author's goal.
The author's thesis, both before and now, is that for a considerable number of reasons it is imperative to restore the definition of "prudence" in the CF, subjected to revision, as an introduction to the International Accounting Standards (IAS) with a clearly defined content to avoid misinterpretation or misunderstanding, which will not impair, but will support "neutrality", and will improve the transparency of financial statements information.
On the basis of long-lasting research alongside the thorough observation of the regulatory process, it is argued by the author that as an organization, developing the accounting norms for many business entities functioning in the EU and elsewhere, the EU accounting standards setter is responsible for the ambiguities or at least misconception due to its prerogatives. Probably a major reason for the inconsistency in the policy with respect to prudence was the influence of political, institutional and other factors in the process of convergence. The development and deliberations as of December 2016 and January and February 2017 as to the revision of the CF have convincingly confirmed that once more.
Keywords: financial reporting; prudence; conservatism; neutrality; hidden reserves; deliberate bias; transparency;

1. INTRODUCTION

Over the past decade and a half profound changes have occurred in financial reporting in Europe and elsewhere, which Hoogervorst described as a revolution (2012)[47], while the decision on the IAS adoption by the EU Member States from January 1st, 2005, the IASB Chairman determined as "a leap into the unknown"[48]. Appreciating the beginning of the process, he assumed that Europe kick-started the move towards global accounting standards (2012), and remarked not long after in London that a year after the adoption, an EC-sponsored study[49] found that "adoption of IFRS had been challenging but ultimately successful. The study concluded that 'there was widespread agreement that IFRS has made financial statements easier to compare across countries, across competitors within the same industry sector and across industry sectors' (2013)."[50]
Long before, prominent scientists as *Professor Jacques Richard* have remained indifferent to the enthusiasm of that change even skeptical about its benefits. Not inspired by the rhetoric of others, *Professor Richard*, accused EU regulatory institutions for adapting accounting principles through compromises in regulations that favour particular interests (2005, *Le Monde diplomatique*, no.1:24-25). Now it is unlikely for such an insight to remain unnoticed even by the opponents.
In the debate focused on the reasons for the changes in EU financial reporting, as well as on the essence of the dominating factors that influence the rulemaking and regulatory processes, scientists are not unanimous – the

[46] IASB IFRS Foundation (July 2013). Discussion Paper 'A Review of the Conceptual Framework for Financial Reporting'.
[47] Hoogervorst, H. (2012), "The Concept of Prudence: dead or alive?", *FEE Conference on Corporate Reporting of the Future*, Brussels, pp. 1-7 (p. 1).
[48] Hoogervorst, H. (2013), "The search for consistency in financial reporting", *A Speech at the CeFARR*, Ernst & Young, Cass Business School, London, pp. 1-8 (p. 1).
[49] EU Implementation of IFRS and the Fair Value Directive *A Report for the European Commission*, available on-line at http://www.icaew.com [29 July 2016]
[50] Hoogervorst, H. (2013), "The search for consistency in financial reporting", *A Speech at the CeFARR* Ernst & Young, Cass Business School, London, pp. 1-8 (p. 2).

forecasts point to more than one perspective while the estimates range from positive to extremely negative. Academics from the UK and the USA have suggested that the monopoly process may not be most efficient (*Fearnley* and *Sunder*, 2005, p. 14)[51]. Now, it is hard to believe that consensus could be achieved.

Since September 2010, the criticism has intensified. The IASB has decided to replace "prudence" with "neutrality", revising the first chapters of the CF. The crucial question that has been raised, was whether it was a change that will probably undermine the essentials of financial reporting, or a significant progress to global consistency, or more likely towards further erosion of "Prudence" in accounting?

Therefore, the primary goal is once more to highlight the necessity of restoring 'prudence' to the CF, and to support that view with comprehensive arguments. As it is stated in previous studies, 'Prudence' may be thought about as a fundamental principle, as a core principle, as a guiding principle, as a major requirement, as an essential theoretical concept underlying financial accounting. …it should not be regarded as a qualitative characteristic of information provided by financial statements.... It is deeply erroneous from a theoretical perspective, in my view. 'Prudence' is, and should be regarded as the primary principle amongst all the traditional accounting principles, to which professional accountants, predominantly analytical and conservative people … have been closely attached for centuries.

The terminology used in the article is relevant to the essence of financial accounting and financial reporting under the CF and the International Accounting Standards (IAS)/International Financial Reporting Standards (IFRS). The structure of the article is subordinated to the author's goal to justify the need for restoring "prudence" to the CF as soon as possible.

The methods of knowledge (analysis and synthesis, induction and deduction, comparison, analogy, observation, descriptive method etc.) are applied for achieving the author's goal since these methods are generally accepted for scientific research in the respective field and are commonly used, due to their universal nature and the predictable results. A wide range of specialized scientific literature has been investigated, and empirical evidence has been provided for the purpose of the research.

2. THE CRITIQUES FOR THE LONG-LASTING EROSION OF "PRUDENCE" IN ACCOUNTING

"We must not forget that a central feature of the recent period of artificial expansion was a gradual corruption, on the American continent as well as in Europe, of the traditional principles of accounting as practiced globally for centuries."[52]

***Jesús Huerta de Soto** (2009)*

"…it is vital that in periods of prosperity we stick to the principle of prudence in valuation, a principle which has shaped all accounting systems from the time of Luca Pacioli at the beginning of the fifteenth century to the adoption of the false idol of the IAS."[53]

***Jesús Huerta de Soto** (2009)*

In his article "A Critical Note on the New International Accounting Rules", focusing on the "innovations" in accounting over the past three decades, *Jesús Huerta de Soto* analyzes the evolution of accounting practices on the American continent, as well as in Europe (2016:1-5)[54]. Discussing the essence of crucial prerequisites and key factors, the author justifies the emergence and development of degradation processes due to the imprudent race for abandoning the old principles of accounting (as being applied for centuries) during the time of "irrational exuberance". A vivid example, in his view, is the erosion of the traditional principle of prudence. Identifying the specific characteristics and "advances" of the "new economy" like electronic commerce, new technologies and communications etc., and the relevant economic cycle ending in a deep crisis of the financial markets, in 2009 the *Spanish Professor* reminded that since 1998[55] and even earlier he had been predicting, that worldwide economic recession would be inevitable (2009, p. xxvi)[56]. The author's standpoint was that the policy of credit expansion for fifteen years backward could not have ended in any other way. Unfortunately, his prediction turned out to be true. Having analyzed the artificial expansion, its essence and possible consequences,

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[51] Fearnley, S. and Sunder, S. (2005), "The headlong rush to global standards", *The Financial Times*, October 27th, p. 14.
[52] Huerta de Soto, J. (2009), *Money, Bank Credit, and Economic Cycles,* Second English Edition, Translated by M. A. Stroup, Auburn, Alabama, Ludwig von Mises Institute, p. xxvi.
[53] Huerta de Soto, J. (2009), *Money, Bank Credit, and Economic Cycles,* Second English Edition, Translated by M. A. Stroup, Auburn, Alabama, Ludwig von Mises Institute, p. xxviii.
[54] Huerta de Soto, J. (2016), "*A Critical Note on the New International Accounting Rules*", Madrid, King Juan Carlos University, pp. 1-5, available on-line at www.jesushuertadesoto.com/articulos [29 July 2016]
[55] Huerta de Soto, J. (1998), *Dinero, Crédito Bancario y Ciclos Económicos,* Económicos, First Spanish Edition, Madrid, Unión Editorial.
[56] Huerta de Soto, J. (2009), *Money, Bank Credit, and Economic Cycles,* Second English Edition, Translated by M. A. Stroup, Auburn, Alabama, Ludwig von Mises Institute, p. xxvi.

he criticized the gradual corruption of traditional "Principles of Accounting" in the United States[57], just as it has been done for many years around the world (2016:1-5, p. 1)[58].

Those forecasts, obviously not optimistic, based on analysis in "Money, Bank Credit, and Economic Cycles" explicitly reveal the key reason for the adverse processes (2009, p. xxvii)[59] – the long-lasting existence of destructive practices during the years of the "bubble", characterized by a feedback loop: rising stock-market values have been immediately entered into the books, and then such accounting entries have been sought as justification for further artificial increases in the prices of financial assets listed on the stock market.

Like many others distinguished Professors in Accounting the outstanding Professor in Political economics has condemned that practice of imprudent valuation, based on hypotheses and criteria considered to be not entirely orthodox as for example practices of evaluation based on somebody's subjective forecasts about sales and possible new clients in the future, of recognition of expenses for advertising activity as assets as well as costs of luring new clients, and, on the whole, that dangerous behaviour of accounting for all future expected incomes in their origin in respect of every contract ("accountancy by flow").[60] Though devoid of common sense, that practice, has developed as more commonly accepted over the years, and has allowed companies with enormous losses (that should have been recognised if the traditional principles were strictly applied) to justify disproportionate growth in their market value for long periods of time, all of which derived from hypotheses that in the long run, proved to be far out of reality (2009, Ibid, p. xxvii).

These considerations are strong enough to explain author's critical approach on one side, and more importantly, to underline our unprejudiced support for that way of thinking, which standpoint I have been upholding (2010, no.1:95-104; 2010:31-37, 2012:235-247; 2013:102-112; 2014:277-290; 2015:403-436; 2015:144-154). "The greatest error of the accounting reform recently introduced worldwide is that it scraps centuries of accounting experience and business management when it replaces the prudence principle, as the highest ranking among all traditional accounting principles, with the "fair value" principle, which is simply the introduction of the volatile market value for an entire set of assets, particularly financial assets" (Huerta de Soto, 2009, p. xxvii-xxix)[61]. The major arguments of Huerta de Soto's, in substance, underlying his critical approach, are as follows:

- *The artificial "wealth effect"* that can be produced by an inflation of book values with surpluses, especially during the boom phase of each economic cycle, which have not materialized and which, in many cases, may never materialize that in turn can lead to *"the allocation of paper (or merely temporary) profits*;
- *The acceptance of disproportionate risks*, and, the *commission of systematic entrepreneurial errors*;
- *The consumption of the nation's capital*, to the detriment of its healthy productive structure and its capacity for long-term growth";
- The motive that the purpose of accounting is to permit the *prudent management of each company and to prevent capital consumption by applying strict standards of accounting conservatism* (based on the prudence principle and the recording of either historical cost or market value, whichever is less); and
- Therefore, to *apply standards which ensure at all times that distributable profits come from a safe surplus*, which can be distributed without in any way endangering the future viability and capitalization of the company.[62]

It would be fair to note as in my previous papers dedicated to the problem (2012, 2013, 2014, and 2015)[63] that some results of my research have led to a conclusion that should be emphasized. Many of the criticism that the Conceptual Framework (CF), the International Accounting Standards (IAS), the International Financial Reporting Standards (IFRS) and the International Accounting Standards Board (IASB) have received over the years refer to one and the same field, moreover, in many cases the criticism are the same in essence.[64] [65]

[57] *Professor Huerta de Soto* argued that the practice begins in 1991 with the declaration of SFAS №107 issued by the US FASB of the Financial Accounting Foundation (FAF.

[58] Huerta de Soto, J. (2016), "*A Critical Note on the New International Accounting Rules*", Madrid, King Juan Carlos University, pp. 1-5 (p. 1).

[59] Huerta de Soto, J. (2009) *Money, Bank Credit, and Economic Cycles,* Second English Edition, Translated by M. A. Stroup, Auburn, Alabama, Ludwig von Mises Institute, pp. 1-938, (p. xxvii).

[60] Ibid.

[61] Huerta de Soto, J. (2009) *Money, Bank Credit, and Economic Cycles,* Second English Edition, Translated by M. A. Stroup, Auburn, Alabama, Ludwig von Mises Institute, pp. 1-938, (pp. xxvii- xxix).

[62] Huerta de Soto maintains the view that in the market there are no equilibrium prices a third party can objectively determine. In his view quite the opposite is true: market values arise from subjective assessments and fluctuate sharply, and hence their use in accounting eliminates much of the clarity, certainty, and information balance sheets contained in the past. Furthermore, the volatility inherent in market values, particularly over the economic cycle, robs accounting based on the "new principles" of much of its potential as a guide for action for company managers and leads them to systematically commit major errors in management, errors which have been on the verge of provoking the severest financial crisis to ravage the world since 1929.

[63] Oreshkova, H. (2014), "Current Fundamental Issues of Corporate Financial Reporting: Past Lessons in Favor of the Future", *Proceedings of the Global Business Conference 2014 'Questioning the Widely-held Dogmas'*, Dubrovnik, Zagreb Innovation Institute, pp. 277-290.

[64] Oreshkova, H. (2013), "The crisis and the future of financial reporting: Global financial reporting standards – reality or utopia", *UNWE: Economic Alternatives, 2013, Issue 2*, pp. 50-75.

Academics, representatives of national and international organizations, and people concerned (from France, Germany, the United Kingdom, the United States, Canada, China, Russia, Eastern Europe and elsewhere) have been criticizing IFRS approaches and models on the basis of arguments, motives etc., identical in substance. Though, as might be presumed, these people have different professional status and experience, expertise and individual culture depending in any case on the influences under which they have developed as specialists in their countries and national accounting systems, the criticism of scientists and other professionals is based on similar even identical considerations. We would try to provide some evidence, further analysis and conclusions.

Back in November 2005, prior to the beginning of the global crisis, *Professor Richard* blamed Brussels for "abandoning the precautionary principle"; he criticized the apologists of the 'true and fair view' for the announcement of a new era due to the set stage appearance of 'accounting standards', which in *Professor Richard's* view resembles manipulation. "… All of us saw – he stated – how under the pretext of 'a true picture' practices having nothing to do with the "science" of accounting thrived, just aiming at simply falsifying the results. Thus, some normally amortizable assets were removed from the net capital to avoid accounting of losses. ... Giving shareholders and management more leeway to maneuver using the so-called accounting based on "principles"…bodes no good (2005, no.1:24-25; 2005, no.620:28-29)."[66] [67]

As far as opinions raised up that banks should reserve for possible losses earlier (*The Financial Times*, March 13, 2009), *Professor Fearnley* replied that banks did until 2005 when the IFRS accounting regime removed the principles of prudence and reliability from accounting, substituting them with neutrality and verifiability, which had two disastrous effects in the banking sector (March 18, 2009)[68] [69]. In her criticism prompted by the violation of the precautionary principle, *Fearnley* exposed the fact that provisioning on loan portfolios was no longer required even though lending has becoming increasingly risky. Thus risky debts have not been covered by an appropriate level of provisioning to cover or protect against the future defaults. Secondly, *Fearnley* points out that marking to market of certain bank trading assets as the market has been bubbling, allowed the recognition of holding unrealized gains as distributable profits. Mark to market assumes that markets (or market based models) behave rationally. However, in *Professor Fearnley's* viewpoint, they do not. *"The numbers were verifiable but were neither neutral nor reliable.* The accounting regime allowed banks to book false profits, arising out of unrealistically low provisioning and unrealized gains, and then to pay dividends and bonuses which were unsupported by future cash flows"[70]. Likewise, the Financial Services Authority Chairman Lord Turner in the same spirit stated (in *Express*, March 19, 2009) that it is necessary to put shackles on banks in an era of prudence (coming, author's add-on). Having his distinguished career given him considerable expertise particularly in regulation and risk management, yet in 2009 Lord Turner warned that banks will be forced to hold much greater levels of capital in reserve to cover their consumer lending and trading activities, and thus urge them to follow more prudent approach.

However, concern has arisen out of dealing with 'toxic' assets. In *Fearnley's* viewpoint the defective accounting regime that has allowed these assets be overstated in the first place should have been of equal concern. Thus, in 2011, at the Second Symposium on Accounting Research, held by ANC, *Fearnley* insisted "if the Group of G20 achieves nothing else it should restore prudence to accounting and scrap mark to market". *Fearnley* concluded that the IFRS accounting model has obscured reality in accounting numbers by allowing suspect valuations and therefore suspect profits to be recognised. Moreover, *Fearnley* argued that yet in 2002 the IASB agreed converge its standards with US GAAP without a full public consultation with its European constituency. Due to this fact she even considered that since then the IASB has not been independent, because it is not independent of the US accounting standard setters and called on that "We should abandon the IFRS bureaucracy in Europe and find our own accounting solutions (2011:54-56)"[71].

It is appropriate to recall here that the EC adopted a "Proposal of Regulation on the Application of International Norms of Accounting" on 13th February 2001. Discussing the motive of the Commission, Huerta de Soto focused on an indicative fact – the EC recognized that the mentioned (that, as known, it has been done by an entity located in London that is entirely private), obeyed the pressure of some European multinationals that for many years envied the possibilities in which their American colleagues had worked in the field of creative

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[65] Oreshkova, H. (2012), "The crisis and financial reporting in the future: Global financial reporting standards – reality or utopia", *Jubilee International Scientific Conference 'Crisis and Economic Growth'*, UNWE, Sofia, University Press, pp. 235-247.

[66] Richard, J. (2005), "L'Union Européenne mise aux normes Américaines: Une comptabilité sur mesure pour les actionnaires", *Le Monde diplomatique,* Bulgares édition, no. 1, pp. 24-25.

[67] Richard, J. (2005), "L'Union Européenne mise aux normes Américaines: Une comptabilité sur mesure pour les actionnaires", *Le Monde Diplomatique*, French Edition, N°620, November, pp. 28-29.

[68] Fearnley, S. (2009), "Restore prudence to accounting", *The Financial Times*, March 18.

[69] Fearnley, S. and Sunder, S. (2012), "Global accounting rules – an unfeasible aim", *The Financial Times*, June 3.

[70] Ibid.

[71] Fearnley, S. (2011), "We should abandon the IFRS bureaucracy in Europe and find our own accounting solutions", *Proceedings of the Second Symposium on accounting research of the Autorité des normes comptables*, Paris, pp. 1-78.

accounting. Analyzing the reason of the proposal for Regulation, Huerta de Soto pointed out that it is literally stated that "the adoption of the International Norms of Accounting further obeys strategic, business and financial considerations rather than accounting concepts (2016, Madrid, p. 2)".

From the perspective of Germany, *Dr. C. René Beul* maintains the view that a closer look at the historical record is necessary, so "…we need to study economic history. …we tend to have insufficient awareness of past economic crises (2011:16-17)"[72]. *Dr. Beul* reminded that Germany had experienced a major crisis caused by "fair value" as in 1873, and so had France in 1857; further discussing the striking parallels with the crisis nowadays, he underlined that the system "current value", objective value or fair price was already known in the nineteenth century, for which the Railway construction offers a good example. "Train stations, tracks and so on were not accounted for at construction cost, but at prices in a non-existent market. People at the time should have realised how risky such an approach was. As far back as in 1675, *Savary* wrote (in *Le Parfait Négociant*) that one should not present oneself as being richer (in the accounts) than one really was, "for that would be like getting rich in thought". For that reason, "[book value] should be equal to cost (Ibid)"[73]. After those crises in the late nineteenth century, the current, objective value approach was abandoned, and accountants adopted the prudence concept, which imposes to record only the costs (as in 1884 in Germany)".

In October 2012 *Professor Milanova* analyzed the fundamental flaws with which the financial system enters the last global crisis and highlighted among them: "too much borrowed capital giving rise to greater indebtedness in the banking and financial system and insufficient highly qualitative equity which to absorb losses; excessive credit growth, based on undervalued standards for management of inherent risk; insufficient liquidity buffers; ... Creating complex opaque financial instruments... (2012:111-119, p. 112)."[74] Further on, in her analysis of macroeconomic viewpoint, focused on the effects of the crisis on the financial system, *Professor Milanova* stated that "The rules of fair value reflected on banks very painfully (2012, p. 113, Ibid)."[75]

In my view the behaviour of people, who have been taking advantage of the opportunity provided by IFRS rules enabling "fair value" or "market value" to be preferred or not and hence be applied selectively, depending on the circumstances and the effect pursued, is discussed with a strong disapproval. And that is reasonable. We saw how destructive management decisions may be detrimental to the public interest – they may have a long-lasting adverse impact on the social status of wide strata of society, not just an entity, industry or other sector of the economy. The opportunity or rather the "chance" provided by IFRS approaches, perhaps not coincidentally, has allowed the wide spreading of vicious practices, practices that have been generating consequences for individuals, enterprises, economies. The policy has been considered depending on the conjuncture; depending on whether by means of deliberate influence on the outcome passing through the model of valuation (that in accordance with IFRS could be revised, that is changed) the "desired" effect can be finally achieved, having in mind the macroeconomic trend. In many cases, that practice was a brutal violation of the requirements designed for "prudence". On the First Symposium on Accounting Research, held by ANC (2010) in Paris, *Professor Yuan Ding*, the Chairman at that time of China Europe International Business School (CEIBS), focused on the pro-cyclical effects of fair value measurement and the subjectivity in fair value valuations in terms of China's example. *Professor Ding* debated reasonably that it seems difficult to claim as it is often done that fair value represents an undeniable progress in accounting. His strong criticism is due to another "innovation". "The real novelty consists in negating the principle of prudence by enabling the recognition of unrealised profits or by allowing astonishing liberties to be taken with accounting prudence as with IFRS in October 2008 or in April 2010 with US-GAAP: in a rising market unrealised profits are recognised; however, when the market turns around, they revert to measurement on the basis of held to maturity, so that the fall in market value is not recognised in profit or loss (Ding, 2010, p. 30)".[76]

In my opinion strong arguments exist in support of the thesis I maintain: the use of fair value valuation raises an important problem with respect to the "going concern principle" and "the liquidation basis" of accounting. Under the going concern basis, the assets are treated together as a unit, as the essential elements for implementing the business model, and as such they are only considered from the point of view of their utility as opposed to their sales values. The "going concern principle" supports measurement at historical cost and justifies the existence of goodwill that comprises and therefore recognises a part of the unrealised profits associated with the acquired assets whereas under the liquidation basis, this unit is broken down into a series of individual assets that can be liquidated separately. The liquidation principle supports fair value measurement of

[72] Beul, C. René. (2011), "The Perspective from Germany", *Proceedings of the Second Symposium on accounting research of the Autorité des normes comptables*, Paris, pp. 1-78.
[73] Ibid.
[74] Milanova, E. (2012), "Accounting aspects of anti-cyclical policy of the banks in Bulgaria", *Jubilee International Scientific Conference 'Crisis and Economic Growth':* UNWE, Sofia, University Press, pp. 111-119 (p. 112).
[75] Ibid.
[76] Ding, Y. (2010), "A Chinese view of accounting issues Reflections on fair value: The Chinese experience", *Proceedings of the First Symposium on accounting research of the Autorité des normes comptables*, Paris, pp. 1-80.

each individual asset but appears inconsistent with the recognition of goodwill. However, the IAS, issued by the IASB, seem to reflect a certain accounting opportunism, in which they allow 'fair value' and 'goodwill' to coexist (Ding, 2010, Ibid)[77].

We (I) confidently maintain the view that financial accounting is a powerful tool for sharing the wealth among all members of society, for its fair distribution between present and future generations, between short-term and long-term perspectives. Unfortunately, through the accounting standards high priority has been given for many years to short-term rather than to long-term performance. From the standpoint of academic, I argue that criticism of researchers and other specialists is based on sufficiently reasonable arguments. It reveals significant management weakness and errors made under the influence of short-sighted policies and decisions aimed at ensuring the best results of the present at any cost without particular concern for the future that the CF and IFRS apparently have been allowing, in many cases in conflict with the philosophy of prudence in accounting. The need for a paradigm shift has been increasingly discussed by scientists and researchers. It is worthwhile to consider the view of *Professor Richard*: "The IFRS are obsolete ... remain stuck in a quaint conception... In an era in which environmental degradation poses a serious threat to the survival of mankind and in which innovation plays an increasingly critical role in international competition, it is environmental and human capital that should be placed in the spotlight of corporate balance sheets and be the focus of systematic monitoring of their depreciation. By focusing uniquely on maintaining financial capital, the IFRS give rise to illusory profits and justify payouts of fictive dividends (CREFIGE: IFRS...Jacques Richard, www.crefige.dauphine.fr)."[78]

Recently, professionals from the UK like Councilor Kieran Quinn, chair of Greater Manchester Pension Fund, chair of Local Authority Pension Fund Forum (LAPFF), Frank Curtiss, Head of Corporate Governance at RPMI Railpen Investments, Natasha Landell-Mills (Sarasin and Partners), Head of ESG Research *et al*., admitted the existence of significant shortcomings and clear evidence of problems with their accounting system in the UK. The supported opinion is that there are solutions to be implemented straightforward (2015)[79]. In their view prudence should be restored as an overriding accounting principle so that capital and performance are not overstated, and moreover, that the "breakdown of realized and unrealized income should be visible to all". These changes are not just vital for effective stewardship by executives, directors and shareholders; they are necessary to bring the accounting framework back into line with existing legal requirements for capital protection as originally set out in the EU's second directive". Unfortunately, these specialists argued that "Whether it is hidden capital weakness in European banks (perhaps continuing until now, author's add-on), directors paying out illegal dividends based on faulty accounts at Betfair plc, or the accounting games exposed at Tesco, it should be clear that – the audit problem aside – something has gone wrong with company accounts." In their view the problem lies with the move in the EU to an accounting system (under IFRS) that prioritizes "neutrality", mostly interpreted as "the absence of bias", over prudence (as stated in the former CF).

My understanding is that only sticking to prudence in accounting, we can ensure that performance and capital are not overstated, which in turn underpins the confidence of shareholders, lenders and all stakeholders in companies' balance sheet strength and capital stewardship. Therefore, it is logical to support that line of reasoning since it stands closely behind the essentials of my thesis. Without prudence, IFRS have relied more heavily on mark to market (MTM) to value assets and performance. With IFRS it is not possible to be certain as to what profits have been realised as cash, or what the capital position really is. This might seem to be an esoteric point, but it has far-reaching impacts for the public interest. Most obviously, MTM gains on trading assets at banks have fed an exaggerated view of profits and capital before the financial crisis. This in turn helped to fuel an excessively risky lending boom (Ibid[80]). People across Europe continue to suffer the cost of that period of excessive optimism. It is a fallacy to suppose that accounts merely provide a window on to the real world. They also shape reality by influencing behaviour. The damage is not limited to the financial sector, highlighted by issues at Tesco. While aggressive accounting will be a problem with any set of standards (and requires robustly independent audit), the lack of prudence permitted by IFRS fuels uncertainty over what has actually been earned. This can in turn lead to inappropriate strategic and operational decisions (Quinn *et. al*., 2015, Ibid[81]).

Though for decades now considerable resources have been spent on improving the CF and resolving issues, subject to intense controversy, many of them still lack unique answers. Among the most critical questions are: how reliable and effective is the evaluation at fair value when markets are in panic or in collapse, highly illiquid and the market value of certain assets virtually "disappears"; how to assess precisely the impairment loss

[77] Ibid.
[78] Richard, J. (2010), "The IFRS are both obsolete and dangerous", *CREFIGE: IFRS... Jacques Richard, University of Paris Dauphine,* available on-line at www.crefige.dauphine.fr [8-9 June 2016]
[79] Quinn, K., Curtiss, F., Landell-Mills, N., Richards, I., Tracey, E., Collinge, R., and Talbut, R. (2015), "Restore prudence as overriding principle", *The Financial Times*, February 15.
[80] Ibid.
[81] Ibid.

consistent with IAS 36 *Impairment of assets* under so many assumptions and estimates imposed by the prescribed methodology? Isn't it naive to believe that professionals with varying degrees of training, expertise, qualification, and respect for ethical codes, laws and standard rules would reason and proceed in the same way if they suspect that impairment has occurred or is looming even if they are under the same conditions, in companies of the same industry sectors etc.? The main question still to be answered is whether financial accounting and reporting nowadays is far from exact science and practice since it depends on numerous assumptions, forecasts, estimates etc. If the subjective decisions are strongly influenced by artificial or false optimism, the backstage of lobbying or extreme conservatism, can it be expected that a government body, an investor, or another stakeholder, could be well informed to take the right action and avoid error? So, we would be closer to reality if we admit that the quality of information produced in accounting as a system depends on internal and external factors, and it is strongly predetermined by the degree of professional qualification, expertise, ethics and morals.

3. THE HYPOTHESIS OF USING THE SYSTEM OF HIDDEN RESERVES

Which was the reason for the CF change in September 2010 concerning "prudence"? Wasn't it a crucial step towards global consistency?

It is true that the old CF definition of prudence contains a warning against excessive optimism and unduly optimistic assumptions, but it is more explicit against the danger of a "passion" for creating hidden reserves and excessive provisioning. What concerns does excessive conservatism cause? In periods of economic upsurge profits are artificially depressed – investors are likely to miss good opportunities. Another criticism we believe could be made, not from the perspective of investors' interests, is that conservatism can be detrimental to budget in periods of "profits' suppression". That is the main reason for the implementation of fiscal mechanisms of regulation for tax purposes in some countries, in order to counteract a tendency towards creating hidden reserves or neutralize undesirable effects on the state budget. From the perspective of modern-day thinking the biggest problem arises during an economic downturn – it is believed that under certain circumstances, hidden reserves may be used to artificially increase revenues or income – it is possible for profits to be "enhanced" to disguise the worsening performance. This is just speculation as to the behavior of a human factor in a particular situation with uncertainty or unknown actions. However, another probability also exists, perhaps remote, of hidden reserves not to be used "destructively" – if for example, the newly appointed Executive Director decides to disclose the real situation. The problem lays not so much in the alleged existence of hidden reserves, but in the likelihood that an accountant or another factor of importance if under pressure, impulse, or temptation might use them for "hiding" the undesirable or adverse results which in turn raises concerns about transparency. The hypothesis that the system of hidden reserves can be used "unhealthily" – for smoothing out results, concealing degraded performance, or to the benefit of corporate interests unrelated to intentions of keeping the enterprise as a going concern, cannot be the reason for "devaluating" another old rule, the application of which is a brilliant illustration of prudence – highly liquid reserves should be created in sufficient amount as it is extremely important to the undertakings of certain types, and to the State as well. As early as in 1939 *the prominent Professor of International Law and Commerce Konstantin Katzarov* whose remarkable career passes through Bulgaria and Switzerland thoroughly discussed the problem (1939).[82] Nowadays, the problem of hidden reserves is not regulated trough the Bulgarian commercial law, but in the tax law and other national regulations.

While the overt reserves are included or recognized explicitly in the statement of financial position (balance sheet), hidden reserves are not. The difference is due to the way they are formed. Besides understatement of assets, hidden reserves can be formed by overestimation of liabilities (e.g. financial obligations, provisions etc.) and in other ways. As to the hypothesis of deliberately influencing the results through the system of hidden reserves we should not overlook the fact – net profit (or loss) and income can be forged in dozens of ways, depending on the policy of corporate governance and its vision for the future, the economic situation, the specifics of the reality in which the entity operates without the presence of any reserves – overt or covert. The problem with the hidden reserves is essential both to the accounting theory and financial reporting practice and deserves to be the subject of separate research.

Supporters of the present-day modern idea of fair value measurement can develop their answers with reasoning of the kind – what refusal could we talk about? There are rules for regularly charging depreciation of non-financial non-current assets; there are descriptions of tests and procedures prescribed for impairment of assets on any suspicion of a reduction in future benefits (probable, though!) they embody; there are rules for recognition of assets' impairment of so many classes and types; for evaluating inventories at the net realisable value when the latter is the lower one; for accruing charges aimed at provisioning in many cases. Others, more tactfully, would summarize: perhaps a debatable issue. But *Professor Richard* replies: "As for the principle of prudence, it exists in the new American conceptual frameworks, as well as in those of the IASB, but it is unrecognizable. He

[82] Katzarov, K. (1939), *Bulgarian Commercial Law: A Systematic Course,* 2nd ed., Sofia, Royal Printing House.

does not mention the obligation to take into account potential losses and to exclude possible gains, but simply for mandatory compliance with some degree of caution, when discretion is required during the assessment; the road to principle of lack of prudence is open (CREFIGE: IFRS... Jacques Richard)!"[83]

My survey reveals the existence of different types of "prudence" or "conservatism". *Professor Dr. Gebhardt*, *Professor Mora* and *Professor Wagenhofer* discuss the importance of "conditional conservatism (news driven, ex post conservatism)"[84], under which unfavorable news are provided in a more timely fashion than good news, and of "unconditional conservatism" (G. Gebhardt, A. Mora, and A. Wagenhofer, 2014:107-116)[85]. Conservatism in accounting is often defined as "recognizing revenues and gains only when they are reasonably certain, while recognizing expenses and losses as soon as they are reasonably possible". In principle, this implies that "bad news" is recognized earlier than "good news" in reported earnings. Though these academics argue that the value of unconditional conservatism (news unrelated, ex ante conservatism), which measures assets at a lower amount than their actual value is doubtful, yet, they admit that it is still a matter of research and conclude that the IASB could try to re-introduce prudence with a clear definition. Moreover, these academics consider that the CF could be a good way of encouraging or incentivizing the type of conservatism that has been shown to create value for capital providers.

4. THE REVIVAL OF "PRUDENCE" – TRUTH OR ILLUSION

Ever since the IASB decided to remove "prudence" from the CF in 2010 and replace it with "neutrality", strong pressure has been exerted to reinstate it. In January 2014, Richard Martin, Head of corporate reporting at ACCA, qualified "prudence" and "accountability" as central to the CF, and admitted that the situation is unsatisfactory since important aspects of setting accounting standards are absent. In persuading the revival of "prudence", the UK Financial Reporting Council (FRC) has been at the forefront of the urge for reinstatement of "prudence". Giving evidence at a House of Lords Economics Affairs Committee hearing, (in July 2014), the FRC Chief Executive Stephen Haddrill admitted that the Council (UK FRC) has been lobbying hard to get "prudence" reinstated within the CF (Ram Subramanian, CPA, "Prudence gets a revival", July 31, 2014).

What are the main reasons for the probable reinstatement of prudence, perceived in the UK as a concept, or as a principle in other continental European countries? The major ones are as follows:

- *Prudence embodies both existing and proposed IAS, and therefore it is important its meaning be specified in the CF as clear as possible, so the prescribed rules might be applied consistently;*
- *Accountants call for requirements concerning prudence in preparing financial statements to counteract management's natural bias towards optimism influencing that process;*
- *Prudence helps to take into consideration the greater concern of investors which in fact is the concern about downside risk rather than upside potential;*
- *The implementation of prudence principle contributes to align, and therefore support both the interests of shareholders and managers and in consequence can reduce moral hazard;*
- *Research of academics has suggested that 'conditional conservatism' (defined as the more timely recognition of losses than gains) has a significant role to play in financial reporting;*
- *The last global crisis has demonstrated the need for "prudence" in the process of making estimates.*

Opponents, who argue against reinstatement of "prudence", mention reasons including:

- *A lack of clear understanding of the term that could lead to different interpretations and inconsistent application in practice;*
- *Exercising prudence could lead to bias in financial statements that is inconsistent with the concept of neutrality;*
- *Inappropriate application could lead to "profit shifting" or "cookie jar accounting", i.e. to the undesirable practice of understating good performance in some years to hide bad performance in future years;*
- *The previous decision made by the IASB to remove prudence from the CF was subjected to an extensive due process and was agreed with the US Financial Accounting Standards Board (US FASB), so reintroducing "prudence" could also mean divergence from the approach applied by the FASB.*

Nevertheless, in May 2014 the IASB tentatively decided to reintroduce reference to prudence in the CF, under revision until now. What we were most interested in was the definition of prudence – exercising caution when making judgments under conditions of uncertainty. Further, it has been finally acknowledged that prudence is

[83] Richard, J. (2010), "The IFRS are both obsolete and dangerous", *CREFIGE: IFRS... Jacques Richard, University of Paris Dauphine,* available on-line at www.crefige.dauphine.fr [8-9 June 2016]

[84] Gebhardt, G., Mora, A., and Wagenhofer, A. (2014), Revisiting the Fundamental Concepts of IFRS, *Abacus: A Journal of Accounting, Finance and Business Studies*, vol. 50, no. 1, pp. 107-116.

[85] Existing research suggests that conditional conservatism is important in debt contracting as it facilitates the monitoring of debt-contracts and reduces cost of debt; it facilitates the access to additional debt funds, and reduces risk-shifting and shareholder-bondholder conflicts over dividends. "The potential value of conditional conservatism for equity holders has been analyzed, focusing on adverse selection and on moral hazard, and shows that general conditional conservatism could reduce in some cases agency costs and opportunities for earnings management, although the optimum level of conditional conservatism is contextual. There is some ambiguous evidence on the effect of conditional conservatism on investment efficiency (Gebhardt, G., Mora, A., and Wagenhofer, A., 2014, 107-116)."

consistent with neutrality and should not allow overstating or understating of assets, liabilities, income or expenses in preparing financial statements. An argument or a rationale can be found in support of the viewpoint or decision for a change in defining 'prudence', visible at a glance – it is the reasoning that if assets are being undervalued now, it may cause the recognition of lowered costs or expenses tomorrow, a bit later in the current period, or in the short-, medium-, or long-term perspective; quite on the contrary – the overstatement of some liabilities now could cause a recognition of higher revenues (exaggerated earnings or income) later. If today we deliberately and on purpose overstate some assets and/or income, tomorrow we might be forced to understate some liabilities and/or expenses, to avoid or prevent turning past exaggerated profits into real current losses.

My observations over the debate in its development substantiates the expectation – if the definition or description of "prudence" is restored into the CF, it will provide a scant explanation. A question immediately arises whether the importance of this problem is not deliberately compromised, which, if true, provokes that line of critical thinking: "The IFRS are dangerous because they embody a systematic and all-out assault on a fundamental principle underlying accounting (already fairly well eroded throughout the 20th century) – the principle of prudence, which forbids statements of potential profits and prescribes disclosures of potential losses. Essentially, the roots of this financial crisis at the dawn of the 21st century can be found in the impudent imprudence of managers and shareholders who are greedy for short-term profit, backed by the pernicious ideology of "modern" financial textbooks, and protected by widespread compliance with the principles of irresponsibility – astronomical salaries and dividends, golden parachutes, liabilities limited to share of capital, etc. By sounding the death knell for the principle of prudence and by even daring to herald a principle of "imprudence" (non-statement of the potential losses during times of bust and statement of the potential profits in times of boom), the IFRS has contributed to the rise to power of the irresponsibility of financial capitalists and their executive agents with devastating results (CREFIGE: IFRS... Jacques Richard)."

In July 2014 the IASB issued the completed version of IFRS 9 *Financial Instruments* which will replace IAS 39 *Financial Instruments: Recognition and Measurement*. IFRS 9 provides revised guidance on the classification and measurement of financial assets, an expected credit loss model for calculating impairment, and the general hedge accounting requirements that were originally published as a part of IFRS 9 (2013). Considering the significance of the IFRS 9 improvements – e.g. loan loss provisioning and others, Hoogervorst admits that accounting standards around the world, including IFRS, US GAAP and UK GAAP, are currently based upon the incurred loss impairment model, designed to limit management's ability to create hidden reserves during the good times that could be used to flatter earnings during the bad times (2014:1-9)[86]. Further, the IASB Chairman points out that "during this most recent crisis the model has been accused of resulting in impairment being 'too little, too late'. In practice … impairment was only recognised just before a loan defaulted. …loan losses were often recognised far too late. As a result, many investors lost trust in the quality of banks' balance sheets…For this reason we decided to move from an incurred loss model to an expected loss model (2014:1-9)"[87]. The new ELM is designed as to be recognised that whenever one buy a financial asset or lend money there is always some level of expected losses associated with it. Full lifetime expected losses need to be recognised when significant credit deterioration has taken place, Hoogervorst admitted, and even more that it should happen long before an actual default occurs.

The expected loss model (ELM) for calculating impairment loss is more forward looking than the incurred loss model (ILM). It is believed that it would contribute to more realistic assessment and recognition of impairments and that "banks will have to clean their balance sheets in a more timely fashion (Hoogervorst)". The ELM model will have impact on risk assessment and the internal credit rating, estimated by the management. The risk assessment, in turn, affects the probability of default, loss in case of default and exposure value for failure.

Yet, what are the present-day results of the ongoing discussion. In the proposed definition of "prudence" in the current Exposure Draft (ED) of a revised CF (May 2015), it is recognised at last that "neutrality is supported by the exercise of prudence". Further on it is stated that "…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 expenses 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 misstatements can lead to the overstatement of income or understatement of expenses in future periods."(2.18)

My findings confirmed that the description of prudence at present is identical with the proposed one at the IASB Meeting in May 2014, it includes the change introduced as of May 2014 IASB Meeting. In my view the motive that justifies the suggested amendment is clear – the IASB decision is aimed at improving the description which I have discussed earlier (GBC 2014, Dubrovnik). In addition, an explanation of the reasons for reinstatement of prudence is included in 'The Basis for Conclusions (BC2.10)', which reveals commonsense and line of reasoning that I have developed in my previous research (2014:277-290).

[86] Hoogervorst, H. (2014), "Charting progress towards global accounting standards": *Conference Singapore*, pp. 1-9.
[87] Ibid.

Therefore the IASB, in paragraph 2.18 of the ED, proposes to reintroduce the term prudence, defined as "cautious prudence", in the CF. The IASB admits that the removal of the term prudence as a result of the 2010 revisions has led to confusion, and perhaps has exacerbated the diversity in its usage. It states that people continue to use the term, but do not always say clearly what they mean. In addition, some have claimed that, as the term was removed, financial information prepared using IFRS is not neutral but is in fact imprudent. Now the IASB thinks that reintroducing the term with clear explanations that caution works both ways (so that assets and liabilities are neither overstated nor understated) will reduce the confusion.

I accept as reasonable the consideration that for investors using financial statements information to make decisions about their investment, any deliberate overstatement or understatement of items is likely to lead to suboptimal decisions and misallocation of capital.

In October 2015 European Financial Reporting Advisory Group (EFRAG), The European Federation of Financial Analysts Societies (EFFAS), Associazione Italiana degli Analisti e Consulenti Finanziari (AIAF), and the International Accounting Standards Board (IASB), reached an agreement or perhaps made a compromise, that the "notion of prudence" should be understood as a broader concept that could help users to assess stewardship and understand whether management is taking more risks than what shareholders are comfortable with (Summary Report: 22 October 2015, Milan, Joint Outreach Investor Event 'Could Profit or Loss (P&L) be more useful'?).

All these recent changes seem to be an indicator for a tentative attempt of returning to a higher degree of prudence in accounting or "rehabilitating" prudence prestige and the respect for it.

After the real threat of bankruptcies of States and governments in Europe, so close until recently, the fear caused by a "comfortable" in some circles hypothesis about lack of transparency and manifestation of risk, suspected in tolerated by prudence principle opportunity to create and absorb "hidden reserves" is hardly so great. However, if it is assumed that hidden reserves are "trouble" that threatens investors and other interested parties, confidently it is less dangerous to society than the euphoria of "artificially exaggerated", "inflated" profits. We are all aware that the generally accepted practice of recognizing imaginary (fictional), unreal assets, "hypothetical", suspicious profits or revenues, often corresponding with doubtful receivables, not supported by cash flows in future, as well as the practice of non-recognition of some depreciation costs or expenses, of provisions in sufficient amount up to the case etc., may generates far-reaching impacts on the social status of millions of people and may have enormous harmful implications, difficult to overcome for a long period of time. Thus, we completely support the view of *Professor Ding* (2010) that it would also be possible to revert to the prudential function of accounting – according to the logic of the going concern principle – which is currently neglected, namely that the risks taken by the joint going concern are borne by both the investors and all the other stakeholders who may even be more exposed than the investors to those risks.

5. AN IASB'S EXPOSURE DRAFT REINTRODUCES PRUDENCE: DOES THE DEBATE ON PRUDENCE END OR DOES IT NOT?

My observation of the development of the debate has given me grounds to argue that the International Accounting Standards Board (IASB) has demonstrated a policy of inconsistency regarding its approach towards 'prudence'. Without difficulties I can provide ample proof for that. Even Macintosh has publicly admitted recently that they, IASB's members, have experienced the influence exerted by the US Financial Accounting Standards Board (FASB). "At the time – the IASB Vice-Chairman admits, "I didn't think it should have been taken out. But there were people who thought it conflicted with neutrality. There are still people who see things that way[88]. But I don't." Further on, Macintosh admits that the influence of the US Financial Accounting Standards Board (FASB) is less strong than it has been[89], and that is slightly compromising, in my opinion (ICAEW Economia, 2015).

Further on, answering the question of why it is worth bother setting prudence back into the Framework (CF), Mackintosh explains that prudence gives people some comfort. He argues that some investors equate prudence with the "true and fair" view, as they believe it will give auditors a tool to help counterbalance management optimism and aggressive accounting policies. Singleton-Green, a manager in ICAEW's Financial Reporting Faculty and his supporters, are quite pleased to see prudence back into the Framework (CF), but others are not, particularly those who see tension between prudence and the concept of neutrality, which, in my view, does not actually exist and this issue is artificially inflated. *Professor Stella Fearnley* from Bournemouth University (UK) rhetorically questioned opponents and comments further on: *"What's neutrality? It's rubbish. Accounts can*

[88] 'Prudence also seems inherently inconsistent with neutrality, so, prudence cannot be incorporated within that concept', in the ACCA's view, and we definitely cannot agree with that understanding specifically.

[89] Mackintosh admitted (2015) that 'when prudence was taken out, the concepts were being developed jointly. The US didn't have it and didn't see why it should be in there, so that probably swayed the IASB at the time. After the Framework became an IASB-only project, a door was opened for prudence to walk back through" (Mackintosh, 2015; Quoted by Lesley Meall).

never be neutral because there are so many judgements in them." As a final point, Mackintosh concludes: "This is an exposure draft. So people can comment again about whether prudence should be in."[90]

However, on the IASB's meeting as of May 18th, 2016[91] the Board tentatively decided to confirm its previous decision and belief, namely that the Exposure Draft 'should' propose to reintroduce an explicit reference to the notion of prudence[92]. However, once again the Board admitted, after prolonged persistence, that: *'2.18. Neutrality is supported by the exercise of prudence'*[93]*, which is my thesis and view I have been standing up for since the outset of the debate, specifically, since the debate was triggered.* The proposed definition is as follows: '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*' *(emphasis refers just to the 'newly' added extension of the definition).*

I have discussed in my previous research on this problem the reasoning that underlies the change (Oreshkova, 2014, p. 282); the notion (idea) is that such kind of misstatements can lead in future periods either to the overstatement of income or to the understatement of expenses. That was the notion of prudence after the decision to change the definition as of May 21st, 2014 (IFRS Foundation IASB Meeting, May, 2014, 20th to 22nd).

In the BC two types of prudence are distinguished: *'cautious prudence', defined as '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 proposes to reintroduce prudence in the Conceptual Framework; and *'asymmetric prudence', defined as 'a need for systematic asymmetry: losses are recognised at an earlier stage than gains are'. The Board upholds the opinion that the Conceptual Framework should not identify 'asymmetric prudence' as a necessary characteristic of useful financial information.*

However, it explains that accounting policies which treat gains differently from losses could be selected in accordance with the proposals in the Exposure Draft only if:

- *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 (i.e. neutral accounting policies are selected); and*
- *their selection is intended to result in relevant information that faithfully represents what it purports to represent.*

On 18th May, 2016, the Board decided to confirm that the revised CF 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. The Board tentatively decided that there is no need to explain in the Basis for Conclusions on the Conceptual Framework that the notion of prudence cannot be used by preparers to override the requirements in IFRS because *the Conceptual Framework already includes a statement that it is not a Standard and does not override any specific Standards*. In addition, it shouldn't be overlooked that the Board directed the staff to explore further whether and how the Conceptual Framework should acknowledge that asymmetric treatment of gains (or assets) and losses (or liabilities) could be selected if such selection is intended to result in relevant information that faithfully represents what it purports to represent.

The IASB tentatively decided (on September 22nd, 2016) that the main body of the revised Conceptual Framework should acknowledge that, in some cases, income may need to be treated differently from expenses and assets differently from liabilities. The Board directed the staff to develop the wording for such an acknowledgement for discussion at a future Board's meeting. On 18th October 2016 the Board tentatively decided that Chapter 2 – Qualitative characteristics of useful financial information of the revised Conceptual Framework should acknowledge that the exercise of prudence does not imply a need for asymmetry – for example, a need for more persuasive evidence to support the recognition of assets than of liabilities or to support the recognition of income than of expenses. Nevertheless, it is admitted that in financial reporting standards such asymmetry may sometimes arise as a consequence of requiring the most useful information.

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[90] Ibid, available at: http://economia.icaew.com/en/features/july-2015/perspective-on-prudence

[91] IASB Staff Paper on 'Tentative decisions for the revised Conceptual Framework' on the subject of the 'Proposals in the Exposure Draft Conceptual Framework for Financial Reporting'.

[92] On May 21st, 2014 the IASB tentatively decided: to reintroduce a reference to prudence in the CF. The description was – the exercise of caution when making judgments under conditions of uncertainty. Contrary to the previous description of prudence, it was acknowledged, for the first time, that the exercise of prudence is consistent with neutrality and should not allow the overstatement or understatement of assets, liabilities, income or expenses; secondly, to discuss in the Basis for Conclusions the significance of prudence for prepares in preparing financial statements and for the IASB in setting Standards.

[93] IASB Staff Paper as of January 2017 Effect of Board redeliberations on the Exposure Draft *Conceptual Framework for Financial Reporting,* Agenda Paper 10D Prudence.

We tend to argue that with its most recent proposals endorsed as of January 2017, the confusion will reign over everything. The Board differentiates between 'cautious prudence' and 'asymmetric prudence', purporting that this would contribute to more clarity, or at least would diminish the ambiguity but specialists and academics, including myself, are afraid that the effect will be just the opposite. One observation is, that way the Board will prescribe the appropriate level and type of prudence. Regarding this reasoning and the above-mentioned proposals IASB is once again criticized because of academic and institutional disagreements.

Authoritative professional institutions like (ICAEW) thoroughly comment on that issue claiming that the conflict between the CF and the essentials of some IAS/IFRS will be intensified and that is true. The view of AAT is also worth to be supported. *They believe that while a principles-based approach to standards prevails, prudence provides a greater degree of assurance than neutrality does, and it is supportive of the inclusion of prudence within the CF.*

However, the conceptual idea of prudence is embedded into already existing IAS/IFRS to a certain extent and in different ways; the notion of the so-called by the IASB 'asymmetric prudence', for example, can be seen in the standards themselves; as per IAS 11 *Construction contracts,* losses on a contract are recognised as soon as they are foreseen, i.e. predicted or expected; specifically, when it is (highly) probable total contract costs to exceed total contract revenue, the expected loss should be immediately recognised as an expense.

In this respect, some disclosure requirements seem to be prudential. As per IAS 11, an entity discloses any contingent liabilities and contingent assets in accordance with IAS 37 *Provisions, contingent liabilities and contingent assets*. It is specified that contingent liabilities and contingent assets may arise from such items as warranty costs, claims, penalties or possible losses. For example, IAS 37 requires disclosure, in specified circumstances, of major assumptions concerning future events affecting classes of provisions. IFRS 13 *Fair Value Measurement* requires disclosure of significant assumptions, including the valuation technique(s) and inputs the entity uses when measuring the fair values of assets and liabilities that are carried at fair value.

In compliance with IAS 37 *Provisions, contingent liabilities and contingent assets* full provision must be made for all the expected losses on onerous contracts, regardless of whether these items have been delivered or not. IAS 37 prescribes asymmetric treatment of contingencies as it differentiates between positives and negatives. Contingent assets can only be recognised if their receipt is virtually certain, whereas contingent liabilities must be recognised if the outflow of resources is more likely than not.

The IFRS criteria prevent recognition of items such as internally generated intangibles (for example, internally generated goodwill) or provide greater thresholds of probability regarding some items recognition as it is the case with capitalisation (or not) of development costs. Non-financial and non-current assets are initially recognised at historical cost, and the basic rule is that a decline in value (carrying amount) must be recognised immediately as an impairment loss for the period over which the entity incurred the loss, whereas increases in values are not recognised until the asset is sold (in case that the cost model of valuation is preferred as a component of the entity's accounting policy).

The depreciation charge for each period should be recognised in profit or loss unless it is included in the carrying amount of another asset, while the revaluation surpluses (excesses) are treated in a more prudential manner, as components of other comprehensive income[94]. Some disclosure requirements as to the notes, designed to reveal the policies relating to sensitivity of evaluations to changes in assumptions, can be seen as prudential. The so-called 'asymmetric prudence' can be seen in variable consideration in IFRS 15 *Revenue from contracts with customers*. However, in the area of financial instruments, there is *basically* no asymmetric recognition.

No doubt that there can be found many examples of non-prudential approach in the IAS/IFRS. For instance, provisions shall not be recognised for future operating losses, since future operating losses do not meet the definition of a liability (in paragraph 10, IAS 37) and the general recognition criteria set out for provisions (in paragraph 14, IAS 37); this is a big question and a key issue; the reasoning is that an expectation of future operating losses is an indication that certain assets of the operation might have been impaired; and what's next, an entity should test these assets for impairment under IAS 36 *Impairment of assets*, the application of which is highly complicated and creates problems in practice.

[94] For example, if an asset's carrying amount is increased as a result of a revaluation under the revaluation model the increase must be recognised in other comprehensive income and accumulated in equity under the heading of revaluation surplus. However, the increase must be recognised in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in profit or loss. If an asset's carrying amount is decreased as a result of a revaluation, the decrease must be recognised in profit or loss. However, the decrease must be recognised in other comprehensive income to the extent of any credit balance existing in the revaluation surplus in respect of that asset. The decrease recognised in other comprehensive income reduces the amount accumulated in equity under the heading of revaluation surplus.

ACCA[95] argues that the approach to prudence regarded as ‘a quality (caution in the face of uncertainty) which should be followed in the preparation of financial statements, is risky, as it encourages earnings management by giving companies the freedom to reduce profits by applying prudence when it is convenient.

CONCLUSIONS

My belief is that the principle or the concept of prudence, not just the term, should be considered to be of the highest priority among the traditional accounting principles as it has been inherent in the philosophy and unique technique of double-entry procedure and accounting ever since its inception as a social practice, later gaining the status of science. In my view prudence is consistent with neutrality rather than in antagonism. It is hard to agree that the foundational idea of prudence, if it is correctly understood, is incompatible with neutrality. In my view, the re-introduction of prudence would not obscure the transparency of financial reports information nor would it weaken their ability to present the economic nature of a transaction or a process in a credible way.

The principle of prudence should be restored in the revised CF (expected) and its importance as an integral part of financial accounting and reporting essentials should be emphasized. The description should be sufficiently distinct and explicit to avoid misunderstanding or misinterpretation. A thorough description would contribute to a greater clarity and consistency. If not, the CF prescriptions would not comply with the essence of a number of standards which embody the conceptual idea of prudence (e.g. IAS 36 *Impairment of Assets*, IAS 16 *Property, Plant and Equipment*, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, IAS 38 *Intangible Assets*, IAS 2 *Inventories* etc.). If restored, it would provide for a reasonable and balanced judgement under conditions of uncertainty in the estimation process.

It is also worth acknowledging something else, even the most accurate and detailed descriptions or definitions would be inadequate if the necessity of exercising policy of prudence in accounting were not perceived as a priority or an essential prerequisite for resilience and viability of the enterprise, as well as a social need.

There was a hypothesis for presumable existence of different types of conservatism, and it has been confirmed. The understanding varies across countries, accounting systems and cultures. We tend to consider that despite its decade-long development, convergence has not advanced significantly. The major differences still exist due to the clash between traditions and long-lasting influences (historical, legal, political, institutional, economic, social, cultural, linguistic, psychological etc.) under which accounting models (Anglo-Saxon or Continental) have developed. The prevailing factors contribute to the establishment of approaches which have dominated the accounting model. *The principle of prudence is closely related to the continental style of governance, the traditional manner of representing companies’ activity based on the long-term vision of business life.* Scientists like Heidhues and Patel (2011) claim that the assumed conceptual superiority of IFRS reflects strong Anglo-American bias in describing continental European accounting models[96] and reasonably question the assumption that the Anglo-American accounting model is superior to other accounting paradigms.

In my view many empowered people belonging to various managerial, regulatory and other authorities of different hierarchical levels from many countries across the world are responsible for admitting grave errors, and for having unreasonable behaviour as officials, executives, administrators etc.

The moral of the probably subsiding crisis is that transparency, based on commonsense, optimally combined with prudence, must become a priority in financial reporting and the presentation and disclosure of relevant financial and non-financial information, both historical and prospective. For this purpose, the approaches, models and rules for recognition and measurement of assets, liabilities and capital components, of costs and revenues/income must be designed, developed and implemented in the spirit of this underlying philosophy.

First of all, we need to restore confidence in the quality of corporate reporting and the information which it provides as well as reestablish trust in the respective bodies and people, authorized to be responsible for its credibility and verifiability.

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[95] In the ACCA’s view, when there is significant uncertainty with regards to an asset or a liability then that should be reflected in the risk premium or adjustment made in reaching either an assessment of any impairment of a historical cost element or one at fair value. It is often the case that external parties may place more weight on downside rather than on upside risks in valuing assets and liabilities. ACCA see an important role for what could be termed prudence in standard setting, particularly in the possibility that there should in some cases be asymmetric recognition of assets and liabilities and gains and losses. This possibility of asymmetry is confirmed in the BC but being so important, in their view, it should be dealt with in the CF itself as a possibility, not a necessity, in Chapter 1 and under the recognition criteria in Chapter 4.

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