To the members of the International Accounting Standards Board

Submitted electronically

Subject: Eumedion's views on 'prudence'

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The Hague, 2 May 2014

Dear members of the IASB,

The debate on the role of 'prudence' in standard-setting continues to draw substantial attention. Even the European Parliament and the European Council demanded that the European Commission will update them on how the Conceptual Framework develops in this respect, as part of the approved regulation to continue to fund the IASB[1]. Eumedion would also like to take the opportunity to provide its views on this topic.

Eumedion is the dedicated representative of the interests of 70 institutional investors, all committed to a long-term investment horizon. Eumedion aims to promote good corporate governance and sustainability in the companies our participants invest in. We regard accounting standards as a critical part of a global financial infrastructure, especially since investors are dependent on the quality of accounting standards for allocating their own and entrusted capital. Together our participants invest over € 1 trillion of capital in equity and corporate non-equity instruments.

Our key views are:

- Useful financial reporting is best served by neutral standards that require neutral application by preparers;

[1] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0258&from=EN

- The standards should require preparers to exercise caution to avoid overly optimistic reporting in situations of high uncertainty;
- A description of what constitutes prudent behaviour of the standard setter, if found, would enhance the Conceptual Framework.

Background

The IASB's current Conceptual Framework for Financial Reporting (the 'Conceptual Framework') highlights concrete principles and lists them as 'qualitative characteristics' of financial information that is useful to investors. These help the IASB produce high quality standards and thereby a high quality accounting framework as a whole. Before 2010, the Conceptual Framework did include a reference to a concept of prudence, without specifying what was meant by the term. Because some believed the word prudence introduced a bias by preparers into financial reporting, the IASB removed it from the Conceptual Framework[2]. This is because the IASB believes that any bias in financial reporting conflicts with the quality of neutrality and therefore with the qualitative characteristic of faithful representation.

Many have suggested that prudence should be reinstated into the Conceptual Framework because they believe it would counteract the inherent optimism of management.

Eumedion would like to share its views on three interpretations of prudence:

1. Prudence defined as 'exercising a conservative bias';
2. Prudence defined as 'exercising caution in making estimates';
3. Prudence defined as 'wise behaviour of the standard-setter'.

1. Prudence defined as 'a conservative bias'

A conservative bias could be exercised either by the preparer in applying standards, by the standard-setter in creating standards, by both preparers and standard-setter, or by none.

Let us start with how a conservative bias by preparers would be managed by all parties involved:

- The preparer would need to judge how conservative they want to be in preparing their financial statements; then
- the investor would need to guess 'how conservative' the preparer has been in applying the standards; and even
- the standard-setter, when setting standards, would then need to take into account that preparers would be required to exercise a most likely quite varying amount of conservatism.

[2] http://www.ifrs.org/News/Press-Releases/Documents/ConceptualFW2010vb.pdf - page 60.

Each of the above mentioned consequences of conservatism will create unnecessary uncertainty and will make it more difficult for investors to analyse financial statements. Pessimistic financial reporting is no improvement over optimistic financial reporting.

There is also the paradox that a conservative recognition of profit in one period is likely to result in recognition of such result in a subsequent period. Compared to neutral application, a conservative bias in accounting therefore results in delayed information to investors. Investors would tend to discover at a later stage that a company is doing well, and also at a later stage that the company is no longer doing so well.

Eumedion therefore concludes that useful financial reporting is best served by a standard-setter that sets neutral standards, and by a requirement for preparers that safeguards neutral application of these standards.

2. Prudence defined as 'exercising caution in making estimates'

Eumedion acknowledges that there are specific situations in which a degree of caution indeed may enhance financial reporting. For example in situations of high uncertainty, or situations that are highly dependent on judgment, preparers should be required to exercise caution to avoid overly optimistic reporting. Since such a requirement relates to preparer behaviour, it is more appropriate to add such requirement to the standards, and not in the Conceptual Framework.

3. Prudence defined as 'wise behaviour of the standard-setter'

Eumedion associates 'prudence' with the behaviour of a wise person. Investors in quite a few jurisdictions are already familiar with the concept of prudence, most commonly known as the concept of a 'prudent man'[3]. This concept, which originated in the 1830's, evolved in the 1950's to 'prudent investor', because the original 'prudent man' principle resulted in decision making that was too conservative, thereby not meeting the investment objectives of the asset owners. The former 'prudent man' principle tended to evaluate investment managers on individual investment decisions, whereas the 'prudent investor' principle evaluated the behaviour of the investment manager more holistically, in the context of managing an entire portfolio. This more holistic view on what is wise behaviour of an investment manager was a big step forward for judging such behaviour.

Prudence in standard-setting might mean that the standard-setter diligently weighs the benefits and risks associated with the many choices it can make in setting standards. For example, it might consider the:

- benefits of the expected resulting financial reporting output for investors;

[3] http://www.oecd.org/finance/private-pensions/2488700.pdf

- risks of complexity for both preparers and investors;
- risks of too little information versus information overload;
- risks of over/understatement of profit or loss (typically an overstatement in one year leads to an understatement in another year and vice versa);
- risks of drafting standards that leave too much room for judgment by the preparer versus standards that, by having too many rules, prohibit preparers from reporting relevant information;
- risks of using fair value when there is an illiquid market;
- risks of loss of faith by investors when resulting balance sheets lag economic reality;
- risks of loss of faith by investors when resulting balance sheets are ahead of economic reality;
- risks that a preparer may try to game the requirements in the standards;
- risks of finishing an imperfect standard, versus the risks of no standard, or continued application of an existing more imperfect standard;
- risks of excessive costs to investors when trying to interpret the resulting financial reports;
- risks of excessive costs to preparers when producing the required financial reports; etc.

Even though Eumedion acknowledges that it may prove quite difficult to agree on what constitutes 'wise behaviour of the standard-setter', such description, if found, would enhance the Conceptual Framework.

If the IASB would like to discuss our views in further detail, please do not hesitate to contact us. Our contact person is Martijn Bos (martijn.bos@eumedion.nl, +31 70 2040 304).

Yours sincerely,

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