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The Challenge of Restoring Prudence to Accounting and Financial Reporting After Decades of Abandonment of Traditional Accounting Prudence

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Info Articles

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Abstract

Over the past two to three decades, many large national and multinational companies operating in the European Union and elsewhere have experienced the effects of the profound regulatory changes in financial reporting, which are discussed in this study. Different, even conflicting, views have been expressed about the benefits of this process, which has affected fundamental accounting principles such as prudence. Academic research on prudence is extensive. Over the past decades, many academic studies have focused on prudence, which has been discussed in our previous work. A wide range of views and even conflicting arguments can be found in the literature. This article focuses on views, considerations, and reflections from an academic and scientific perspective to support the thesis and critical analysis justifying the need to follow prudence in accounting and financial reporting. 'Prudence' has been reintroduced in the 2018 Conceptual Framework for Financial Reporting (CF), which has always been considered the essential introduction to the International Accounting Standards (IAS) generally defining their philosophy. This article presents views, arguments, and findings based on long research prompted by the decision of the International Accounting Standards Board (IASB) to revise the CF in September 2010 and to remove 'prudence' in favour of 'neutrality', which is considered to be a qualitative characteristic of the financial statement information. It is not the author's intention to discuss the role of the CF or its objectives. The purpose of this study is to discuss the ongoing debate (despite the reintroduction of 'prudence" in the 2018 CF) on a complex and highly controversial issue that has been raised in the Discussion Paper (DP) and the Exposure Draft (ED), both of which contain proposals for a revised CF (January 2014, May 2015). The author's thesis then, as now, is that for a considerable number of important reasons, it was imperative to restore the definition of 'prudence' in the CF, to define its meaning as clearly as possible in order to avoid misinterpretation or misunderstanding, and to do so in a way that does not compromise or impair, but rather supports, 'neutrality'. The CF has been under consideration by IASB members for a long time. It was expected in 2016 and even earlier, but was not issued by the IASB until March 2018. The terminology is mainly in the area of financial accounting and reporting under the Conceptual Framework, the International Accounting Standards (IAS), and the International Financial Reporting Standards (IFRS). The structure of the article is subordinated to the author's objective to justify in an appropriate way that 'prudence' should have been reintroduced in the CF as it has been achieved in 2018. The heuristic methods of knowledge used to achieve the author's objective – analysis and synthesis, induction and deduction, comparison, analogy, observation, descriptive method, etc. – are generally accepted for scientific research in the field concerned and are often used because of their universal nature. A wide range of scientific literature, including foreign sources, has been reviewed and analyzed and the author has provided empirical evidence to support the thesis.

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INTRODUCTION

More than two decades ago, the European Parliament and the Council of the European Union (EU), having regard to the Treaty on the establishing the European Community, and in particular Article 95(1) thereof, having regard to the proposal from the Commission, and to the opinion of the Economic and Social Committee, and acting in accordance with the procedure laid down in Article 251 of the Treaty, have adopted Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards (*Official Journal of the European Union*, L 243, 11 September 2002)[1]. The objective of Regulation (EC) No 1606/2002 is to promote the adoption and further use of international accounting standards in the Community in order to harmonize the financial information presented by the companies referred to in Article 4, thereby ensuring a high degree of transparency and comparability of financial statement information and hence the efficient functioning of the Community capital market and the internal market (Article 1)[2].

The profound changes in the EU in the area of accounting and international financial reporting have been described as a revolution (Hoogervorst, 2012)[3]. The decision to adopt international accounting standards in the EU Member States from 1 January 2005 was described by the former IASB Chair as a leap into the unknown (Hoogervorst, 2013)[4]. Hoogervorst (2012) even suggested that Europe had started the move towards global accounting standards. "The rest of the world looked on with interest", he later noted in London, pointing out that a year after the adoption, an EC-sponsored study[5] found that "the adoption of IFRS had been challenging but ultimately successful. The study concluded that there was widespread agreement that IFRS have made financial statements easier to compare across countries, across competitors within the same industry sector and across industry sectors" (Hoogervorst, 2013)[6].

Long before, and still today, eminent European academics from France, the UK, Germany, and overseas were indifferent to the enthusiasm for the change and even skeptical about the benefits it could bring. "The evocation of a new era, thanks to the entry into the scene of "accounting principles", is already akin to manipulation: it is, for example, difficult to claim that the American accounting before Enron was an accounting without principles. The United States has played a leading and pioneering role..."[7] (Richard, J., 2005). Unimpressed by the inspired rhetoric of others, Professor Jacques Richard accused the EU's regulatory institutions of avoiding or failing to promote accounting principles that have been in use for centuries with priority, or of adapting them through regulatory compromises in favour of particular interests (November 2005, *Le Monde diplomatique*, No. 1, pp. 24-25). Now that countries are recovering slowly and unsteadily from the consequences of several global crises on an unprecedented scale, it is unlikely that this insight will go unnoticed even by its opponents.

On the other hand, it cannot be ignored the fact that companies in more than one hundred and sixty-eight countries, including three-quarters of the G20, apply IFRS, a set of standards that was barely used a little more than twenty years ago. Academics, experts, and practitioners are not unanimous and do not agree on key issues, such as the nature of the real drivers of change in accounting and financial

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[1] European Union Law, Document 32002R1606, Date of the document: 19/07/2002, Date of effect: 14/09/2002, Entry into force: Date publication + 3, See Art 11, Date of end of validity: No end date, available at: https://eur-lex.europa.eu/eli/reg/2002/1606/oj, last accessed on 9 July 2002

[2] Ibid.

[3] Hoogervorst, H. (2012). "The Concept of Prudence: dead or alive?", *FEE Conference on Corporate Reporting of the Future*, Brussels, pp. 1-7 (p. 1).

[4] 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).

[5] EU Implementation of IFRS and the Fair Value Directive *A Report for the European Commission*, available online at: http://www.icaew.com, last accessed 29 July 2023.

[6] 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).

[7] Richard, J. (2005). "L'Union Européenne mise aux normes Américaines: Une comptabilité sur mesure pour les actionnaires", *Le Monde diplomatique*, French Edition, No. 620, Novembre, pp. 28-29, available at: https://www.monde-diplomatique.fr/2005/11/RICHARD/12911, last accessed on 9 July, 2023.

reporting in the EU and the main factors influencing the rule-making and regulatory processes and their effectiveness. Conclusions and predictions point to more than one perspective, and estimates of the benefits of these processes range from positive to extremely negative. UK and US academics have even suggested that a monopoly process may not be the most efficient (Fearnley and Sunder, 2005, p. 14)[8].

Logically, and not unexpectedly, the discussions have intensified since September 2010, when the IASB, in revising the first chapters of the CF, replaced 'prudence' with 'neutrality' as a qualitative characteristic. It is admitted, that mistakes were made (UK Shareholders' Association, 2013). The question at the time was whether this was merely a matter of linguistic expression or a change that undermined the conceptual basis of accounting and financial reporting. Perhaps it was a step towards global consistency or a further step towards the erosion of prudence in accounting. It is difficult to see how a consensus can be reached. The heated debate on prudence continues, even though the IASB has changed its standpoint and reintroduced prudence in the (2018) Conceptual Framework for Financial Reporting.

DECADES OF GRADUAL ABANDONMENT OF TRADITIONAL PRUDENCE IN ACCOUNTING: CRITICISMS AND REFLECTIONS FROM WORLD-RENOWNED ACADEMICS

"Despite the appearances, accounting is a highly political matter because it reflects the view of an enterprise and therefore society. With the decision to assign the rights of developing its normative requirements to a private organization under American influence, the European Union has made a clear choice: to side with the shareholders, which speaks volumes about the "social model" that it intends to introduce."[9]

Professor Emeritus Jacques Richard
Le Monde diplomatique 2005
Bulgarian edition

In 2009, the world-renowned Professor Jesús Huerta de Soto[10] wrote: "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".[11] [12] In Huerta de Soto's (2016) impressive article "A Critical Note on the New International Accounting Rules", which focuses on the "innovations" in accounting over the last three decades, Huerta de Soto analyzes the evolution of accounting practices on the American continent as well as in Europe (2016, pp. 1-5)[13]. The author discusses the nature of the decisive conditions, crucial prerequisites, and key factors for the emergence and development of degradation processes due to the irresponsible, imprudent race to abandon the old accounting principles (as applied for centuries) in the era of "irrational exuberance" and "new economy". A vivid example of this, in his view, is the erosion of the traditional principle of prudence. Identifying the specific characteristics and "advances" of the "new economy", such

[8] Fearnley, S. and Sunder, S. (2005). "The headlong rush to global standards", *The Financial Times*, p. 14, October 27.
[9] 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.* A translation of the cited article by Professor Jacques Richard, published in *Le Monde diplomatique, Bulgarian edition, November 2005.*

[10] Jesús Huerta de Soto is a Spanish economist of the Austrian School, Professor at the King Juan Carlos University and a Senior Fellow at the Ludwig von Mises Institute, awarded with King Juan Carlos International Prize for Economics, Adam Smith Prize, and Franz Keuchel Prize for Excellence in Economic Education.

[11] 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.
[12] Jesús Huerta de Soto is a Spanish economist, Professor at the King Juan Carlos University and a Senior Fellow at the Ludwig von Mises Institute, awarded with King Juan Carlos International Prize for Economics, Adam Smith Prize, and Franz Keuchel Prize for Excellence in Economic Education.
[13] Huerta de Soto, J. (2016). "*A Critical Note on the New International Accounting Rules*", Madrid, King Juan Carlos University, pp. 1-5, available online at: www.jesushuertadesoto.com/articulos, last accessed 29 July 2023.

as e-commerce, new technologies, and communications, etc., and the corresponding economic cycle that ended in a deep crisis of the financial markets, the Spanish professor recalled in 2009 that he had been predicting the inevitability of a global economic recession since 1998 and even earlier (Huerta de Soto, 2009, p. xxvi)[14]. The author (2009) argued that fifteen years of artificial credit expansion could not have ended otherwise. Unfortunately, his prediction turned out to be correct. After analyzing the artificial expansion, its spirit, and possible consequences, Huerta de Soto criticizes the gradual corruption of the traditional principles of accounting in the United States[15], just as it has been happening for many years around the world (2016, pp. 1-5, p. 1)[16]. These forecasts, obviously not optimistic but rather realistic, are based on the analysis in "Money, Bank Credit, and Economic Cycles", and explicitly reveal the main reason for the adverse processes (2009, p. xxvii)[17] – the prolonged existence of harmful practices during the "bubble" years, 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. The eminent Professor of political economy has condemned the practice of imprudent valuation based on hypotheses and criteria that are not considered entirely orthodox. Examples include sales forecasts, the probability of new customers in the future, the recognition of advertising expenses or costs as assets and the costs of attracting customers, and, in general, the dangerous practice of accounting for all future expected revenues in their origin for each contract," (Huerta de Soto, 2009).[18]

The foregoing considerations are strong enough to explain, on the one hand, the author's critical approach and, no less importantly, to emphasize my unbiased support for this way of thinking, a position I have maintained over the years and expressed in my previous works dedicated to this problem (Oreshkova, 2010, pp. 95-104; 2012, 235-247; 2013, pp. 50-75; 2013, pp. 102-112; 2014, pp. 277-290; 2015, pp. 403-436; 2016, pp. 171-189; 2017, pp. 343-380; 2018, pp. 1005-1019)[19]. "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)[20]. Huerta de Soto's main arguments, which justify his critical approach and which are highlighted in his book, are the artificial "wealth effect" that can be generated by the inflation of book values, especially during the boom phase of each economic cycle, with surpluses that have not materialized and which, in many cases, may never materialize. This can lead to "the allocation of paper (or merely temporary) profits, the acceptance of disproportionate risks, and, in short, the commission of systematic entrepreneurial errors

[14] 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.

[15] Huerta de Soto states that the practice began in 1991 with the publication of SFAS №107 by the US FASB of the Financial Accounting Foundation (FAF) as the application of the traditional principle of prudence was gradually abandoned and replaced by the principle of market value or "fair value" in calculating the value of assets in financial statements, especially assets of a financial nature. Huerta de Soto blames investment banks and funds, and all those interested in "inflating" the results in their financial statements, for exerting a great pressure to abandon the traditional principle of prudence to adjust their accounting value to a supposedly more "objective" quotation that would not cease to rise in an economic process of financial euphoria.

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

[17] 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).

[18] Ibid.

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

[20] 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).

and the consumption of the nation's capital, to the detriment of its healthy productive structure and its capacity for long-term growth; the purpose of accounting, which is to allow the prudent management of each company and to prevent the consumption of capital by applying strict standards of accounting conservatism (based on the principle of prudence and the recording of historical cost or market value, whichever is the lower), standards that ensure at all times that distributable profits result from a safe surplus that can be distributed without in any way endangering the future viability and capitalization of the company," (Huerta de Soto, 2009).[21]

Huerta de Soto maintains the view underlying his theory that there are no equilibrium prices in the market that can be objectively determined by a third party. In the author's view, quite the opposite is true; market values arise from, or are derived from subjective assessments, and they fluctuate sharply, i.e., they are highly volatile, so that their use in accounting eliminates much of the clarity, certainty, and information that balance sheets used to contain in the past. He argues that balance sheets have now become largely unintelligible, i.e., incomprehensible, and useless to economic agents. Moreover, "the volatility inherent in market values, particularly over the economic cycle, deprives 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," (Huerta De Soto, 2009).[22]

Some of the results of my previous research on this topic (2012, 2013, 2014, 2015, 2016, and 2017) have led to an important conclusion. The criticisms that the Conceptual Framework, the International Accounting Standards (IAS), the International Financial Reporting Standards (IFRS) and the International Accounting Standards Board (IASB) have received over the years relate to the same area of concern and, in many cases, are essentially the same. Academics, representatives of national and international organizations, stakeholders and other interested parties from France, Germany, the United Kingdom, the United States, Canada, China, Russia, Eastern Europe, and elsewhere have criticized IFRS approaches and models on the basis of arguments, motives, etc. that are essentially identical. Although, as might be expected, these people have different social and professional status, experience, expertise, and individual culture, shaped by the national accounting system and the influences under which they have developed as professionals in their countries, the criticisms are based on similar or even identical considerations. Evidence, analysis, and conclusions are then presented.

As early as November 2005, before the start of the 2008 global crisis, Professor Jacques Richard blamed Brussels for "abandoning the precautionary principle" and criticized some apologists for heralding a new era with the introduction of accounting standards that, in his view, resembles manipulation. "All of us saw how under the pretext of "a true picture" practices that have nothing to do with the "science" of accounting have thrived, just aiming at simply falsifying the results. For example, some normally amortizable assets were removed from net capital in order to avoid accounting for losses... Giving shareholders and management more leeway to maneuver using the so-called accounting "based on principles"…bodes no good, does not bode well," (2005, No. 1, pp. 24-25; 2005, No. 620, pp.28-29).[23] [24]

Responding to suggestions that banks should have set aside provisions for potential losses earlier (*The Financial Times*, 2009) UK Professor Stella Fearnley replied that banks had done so until 2005, when the IFRS accounting regime removed the principle of prudence and reliability from accounting, substituting them with neutrality and verifiability, with disastrous consequences for the banking sector (2009)[25] [26]. In the article, Fearnley highlighted the fact that provisioning for loan portfolios was no longer

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[21] Ibid.
[22] Ibid.
[23] 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.
[24] Richard, J. (2005). "L'Union Européenne mise aux normes Américaines: Une comptabilité sur mesure pour les actionnaires", *Le Monde diplomatique*, French Edition, No. 620, Novembre, pp. 28-29, available at: https://www.monde-diplomatique.fr/2005/11/RICHARD/12911, last accessed on 9 July, 2023.
[25] Fearnley, S. (2009). "Restore prudence to accounting", *The Financial Times*, March 18.

required even though lending had become increasingly risky. Risky loans were not backed by adequate levels of provisioning, i.e. by adequate coverage or protection against future defaults. Second, Fearnley points out that the marking to market of certain bank trading assets during the market bubble allowed unrealized gains of holding to be recognized as distributable profits. Mark-to-market assumes that markets (or market-based models) behave rationally. In Professor Fearnley's view, they do not. "The numbers were verifiable, but were neither neutral nor reliable. The accounting regime allowed banks to record false profits, arising from unrealistically low provisioning and unrealized gains and then to pay dividends and bonuses that were not supported by future cash flows."[27]

Similarly, the Chair of the Financial Services Authority, Lord Turner, said (in the *Express* in March 2009) that in an era of prudence (coming, adds-on) it was necessary to put shackles on the banks. In 2009, Lord Turner, who has a strong background in regulation and risk management, warned that banks would be forced to hold higher levels of capital to cover their consumer lending and trading activities and urged a more prudent approach.

Academics have also raised concerns about the handling of toxic assets. For Fearnley, the flawed accounting system that allowed such assets to be overvalued in the first place should be of equal concern. Thus, at the ANC's Second Symposium on Accounting Research (2011), she insisted that "if the G20 group achieves nothing else, it should restore prudence to accounting and scrap mark to market"[28]. Fearnley concluded that the IFRS accounting model had obscured the reality of the accounting figures by allowing suspect valuations and, therefore, suspect profits to be reported. In addition, Fearnley argued that the IASB had agreed in 2002 to converge its standards with US GAAP without full public consultation with its European constituency. For this reason, she argued that the IASB was not independent because it has not been independent of the US accounting standard setters since then, and called for Europe to abandon the IFRS bureaucracy and find its accounting solutions (2011, pp. 54-56).[29] [30]

It should be recalled that on 13 February 2001, the European Commission (EC) adopted a "Proposal for a Regulation on the application of international accounting standards". In discussing the Commission's motives, Huerta de Soto focused on one indicative fact. The EC recognized that the aforementioned proposal (which, as is well known, was drawn up by an entirely private body based in London) was a response to pressure from some European multinationals, which for many years had envied their American counterparts for their creative accounting. Analyzing the reasons for the proposed regulation, Huerta de Soto points out that it states that "the adoption of the International Norms of Accounting further obeys strategic, business and financial considerations rather than accounting concepts" (2016, p. 2)[31].

From a historical perspective, Dr. Carsten René Beul argues that a closer look at the historical record is necessary, "we need to study economic history… we tend to have insufficient awareness of past economic crises" (2011, pp. 16-17)[32]. He recalled that Germany had experienced a major "fair value" crisis in 1873, as had France in 1857. In discussing the striking parallels with the crisis that began in 2008, he emphasized that the system of current value, objective value, or fair price was already known in the nineteenth century, of which the railway construction is 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 realized how risky such an approach was. As far back as 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

[26] Fearnley, S. and Sunder, S. (2012). "Global accounting rules – an unfeasible aim", *The Financial Times*, June 3.
[27] Ibid.
[28] Fearnley, S. (2009). "Restore prudence to accounting", *The Financial Times*, March 18.
[29] 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*, pp. 1-78, Paris.
[30] Fearnley, S. and Sunder, S. (2012). "Global accounting rules – an unfeasible aim", *The Financial Times*, June 3.
[31] Huerta de Soto, J. (2016). "*A Critical Note on the New International Accounting Rules*", Madrid, King Juan Carlos University, pp. 1-5 (p. 1).
[32] 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.

would be like getting rich in thought'. For that reason, '[book value] should be equal to cost'. 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)".[33]

In October 2012, Professor Milanova, former deputy governor of the Bulgarian National Bank, analyzed the fundamental flaws with which the financial system entered the last global crisis highlighting among them: "Too much borrowed capital, giving rise to higher indebtedness in the banking and financial system and insufficient high quality equity, which to absorb losses; excessive credit growth, based on underestimated standards for managing inherent risk; insufficient liquidity buffers; ...creation of complex opaque financial instruments" (2012, p. 112)[34]. Furthermore, in her analysis from a macroeconomic perspective, focusing on the impact of the crisis on the financial system, Professor Milanova stated that "the fair value rules were very painfully reflected in the banks" (2012, p. 113).[35]

On 19 November 2015, Marlowe argued that many of the US Governmental Accounting Standards Board's most important stakeholders have disagreed with the Board's interpretation of fair value. "There is no question that they have applied that definition clearly and consistently,", in other words, "they have resisted the temptation to politicize this arcane but crucial corner of accounting. That's bringing some badly needed fairness to fair value."[36]

Proponents of today's modern approach, based on the concept of fair value measurement, can develop their answers by arguing along the lines of: "What denial of prudence can we talk about?" There are rules for the regular depreciation of non-financial fixed assets; there are descriptions of tests and procedures prescribed for the impairment of assets whenever there is a suspicion of a reduction in the future (albeit probable) benefits embodied in the assets; there are rules for the recognition of impairment of assets of so many categories, classes and types; for the valuation of inventories at net realizable value when the latter is the lower; for the accrual of charges aimed at provisioning in many cases. Others would summarise more tactfully: perhaps a controversial issue. However, Professor Jacques 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 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 the principle of lack of prudence is open," (Professor Jacques Richard, 2005)[37].

My research has shown that there has been strong disapproval in professional circles of the behaviour of those who have taken advantage of the opportunity to prioritize or not prioritize 'fair value' or 'market value' and thus to apply IFRS rules selectively, depending on the circumstances and the effect to be achieved. We have seen how destructive management decisions can be detrimental to the public interest – they can have a long-lasting negative impact on the social status of broad sections of society, not just a company, an industry, or other sectors of the economy. The opportunity, or rather the "chance", offered by IFRS approaches has, perhaps not coincidentally, allowed the spread of malicious practices, practices that have had consequences for individuals, companies, and economies. In many cases, the accounting policy has been considered according to the economic situation; depending on whether the "desired" effect could be achieved by deliberately influencing the result through the valuation model (which could be revised, i.e. changed, according to IFRS), taking into account the macroeconomic trend. At the First Symposium on Accounting Research organized by the ANC (2010), Professor Yuan Ding,

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[33] Ibid.
[34] 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).
[35] Ibid.
[36] Marlowe, J. (2015). "Is 'Fair Value' Accounting Actually Fair?", Governing: The Future of States and Localities, November 19, 2015, available at: https://www.governing.com/archive/gov-fair-value-accounting.html
[37] Richard, J. (2010), "The IFRS are both obsolete and dangerous", CREFIGE: IFRS… Jacques Richard, University of Paris Dauphine, available online: at www.crefige.dauphine.fr, last accessed 9 June 2023.

Chairman of the China Europe International Business School, focused on the pro-cyclical effects of fair value accounting and the subjectivity of fair value measurement using the example of China. Professor Ding argues that it is difficult to argue, as it is often done, that fair value is an undeniable advance in accounting. His strong criticism is based on another "innovation". "The real novelty consists in negating the principle of prudence by enabling the recognition of unrealized 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 unrealized profits are recognized; however, when the market turns around, they revert to measurement based on the 'held to maturity' model, so that the fall in market value is not recognized in profit or loss (Ding, 2010, p. 30)".[38]

It is fair to say that the ability under IFRS to use fair value raises an important issue in relation to the going concern concept and the liquidation basis of accounting because I think there are strong arguments in favour of this thesis, supported by Ding. Under the going concern basis, the assets are treated together as a unit, as essential elements necessary for the implementation of the entity's business model, and as such assets are considered only from the point of view of their utility, as opposed to their sale value. The going concern concept supports the valuation at historical cost and justifies the existence of goodwill, which includes and therefore recognizes part of the unrealized (probable, future) gains associated with the acquired assets. Under a liquidation basis, this unit (of assets that were linked within the entity's business model) is 'broken down' into a series of individual assets that can be sold separately or liquidated. The liquidation basis supports the fair value measurement of each asset but appears to be inconsistent with the recognition of goodwill. However, the IAS issued by the IASB seems to reflect a certain accounting opportunism – Professor Ding argues, by allowing 'fair value' and 'goodwill' to coexist (Ding, 2010)[39].

I continue to believe and support the view that financial accounting is a powerful tool for sharing wealth among all members of society, for distributing it fairly between present and future generations, and between short-term and long-term perspectives. Unfortunately, for many years, accounting standards have given high priority to short-term rather than long-term performance. From an academic point of view, I would argue that the criticism of academics and other specialists is based on sufficiently reasonable arguments. It highlights significant management weaknesses and errors made under the influence of short-sighted policies and decisions aimed at achieving the best results in the present at all costs, without particular concern for the long term, which the CF and IFRS seem to have allowed, in many cases in contradiction with the philosophy of prudence in accounting. Academics and researchers have increasingly discussed the need for a paradigm shift. It is worth considering Professor Richard's view: "The IFRS are obsolete because they do not respond to issues in the contemporary world. They remain stuck in a quaint conception that views financial capital and investors alone as the Alpha and Omega for managing accounting. 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. The IFRS should give way to an environmental accounting suited to the needs of the current emergency"[40] (Jacques Richard, Professor Emeritus of Accounting).

It is not surprising that Joseph Zorgniotti, speaking at the First Symposium on Accounting Research in Paris (2010), said: "The Superior Council of the OEC[41] is dedicated to preserving solid links with

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[38] 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.
[39] Ibid.
[40] Jacques Richard. "The IFRS are both obsolete and dangerous" Paris-Dauphin University, available online at: http://www.crefige.dauphine.fr/recherche/actualite/richard1.htm, last accessed 11 July 2023.
[41] The Ordre des Experts-Comptables (Institute of Chartered Accountants), or OEC, is a professional organization of Chartered Accountants in France established by Ordinance of the French government in 1945 and based in Paris, France.

fundamental research so that such association is able to avoid the brutal and systematic acculturation of our accounting standards... The principle of prudence is the perfect illustration of this point. Indeed, this principle is linked to our style of governance, to our traditional manner of representing the activity of companies, based on a long-term view of business life and not focused solely on their volatility,"[42] (Zorgniotti, J., 2010, p. 11).

Eminent UK experts such as Councillor Kieran Quinn, Chair of the Greater Manchester Pension Fund, Chair of the 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 and others acknowledged (2015) the existence of significant shortcomings and clear evidence of problems with the UK accounting system[43]. In their view, prudence should have been restored as the overriding accounting principle so that capital and performance are not overstated, and that the "breakdown of realized and unrealized income should be visible to all". These requirements are not only essential for effective stewardship by managers, directors, and shareholders but also necessary to align the accounting framework with existing capital protection requirements as originally set out in the EU's Directives. These experts argued that "whether it is the hidden capital weakness in European banks, the directors paying illegal dividends based on faulty accounts at Betfair plc, or the accounting games exposed at Tesco, it should be clear that – apart from the audit problem – something has gone wrong with corporate accounts". In their view, the problem lies in the EU's move to an accounting system (under IFRS) that prioritizes "neutrality", mostly interpreted as "absence of bias", over prudence as stated in the previous CF.

I believe that by applying a prudent approach to accounting and financial reporting, we can ensure that our performance and capital are not overstated, as prudence does not conflict with neutrality, but supports it. This would underpin the confidence of shareholders, lenders, and all stakeholders in the strength of companies' balance sheets and the management of capital. It is therefore logical to support this line of reasoning, as it goes to the heart of my thesis. Without prudence, IFRS would have to rely more on mark-to-market to value assets and performance. Under IFRS, it is difficult to be sure about the extent to which assets are covered by cash, what profits have been realized as cash, or what the capital position of the company is. This can have far-reaching implications for the social status of large strata of society. It is likely that, people across Europe are still paying for this period of excessive optimism. Most obviously, mark-to-market gains on banks' trading assets fed an exaggerated view of profits and capital before the 2008 crisis. This, in turn, helped fuel an excessively risky credit boom.[44] It is a fallacy to assume that accounts are merely a window into the real world. Accounts also shape reality by influencing people's behaviour. The damage is not limited to the financial sector, as the problems at Tesco have shown. Indeed, aggressive accounting will be a problem with any set of standards (and requires a robust independent audit). The lack of prudence allowed by some IFRS fuels uncertainty about what has been earned. This, in turn, can lead to inappropriate strategic and operational decisions (Quinn et. al., 2015).[45]

Although considerable resources have been devoted for decades to improving the CF and resolving highly controversial issues, many of them still have no clear answers. Among the most critical questions are: how reliable and effective is fair value measurement when markets are in panic or collapse, highly illiquid and the market value of certain assets virtually "disappears"; how can impairment losses be accurately measured in accordance with IAS 36 *Impairment of Assets*, given the many assumptions and estimates imposed by the prescribed methodology? Isn't it naive to believe that professionals with different levels of training, expertise, qualifications, and respect for ethical codes, laws, and standards would think

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[42] Zorgniotti, J., (2010), "Turn accounting into a meaningful art", *The First Symposium on accounting research*, ANC, Paris.
[43] 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, 2015.
[44] Ibid.
[45] Ibid.

and act in the same way when they suspect that an impairment has occurred or is imminent, even if they are in the same circumstances, in the same industry, etc.?

THE EFFORTS OF ACADEMICS, INSTITUTIONS AND THE IASB TO RESTORE A DEGREE OF RESPECT FOR PRUDENCE IN ACCOUNTING AND FINANCIAL REPORTING

Since the International Accounting Standards Board decided to remove prudence from the CF (2010) and replace it with 'neutrality' because of the perceived inconsistency between the two, there has been much criticism. Examples of well-founded criticism can be found in the literature. Was this criticism unfounded? What was the reason for the CF change to "prudence" in September 2010? Is this perhaps the next "decisive" step towards global consistency? Under pressure from academics, the investor community, politicians, regulators, and the profession, the IASB has announced plans to reintroduce an explicit reference to prudence and an explanation of its meaning. In response to criticisms and recommendations made to the IASB by professional organizations, associations, and institutes of accountants from the UK, France, Germany, and other countries, by shareholders, investors, accountants, analysts, and auditors, the Board (IASB) stated that the reason for omitting the word 'prudence' was related to an attempt to be unambiguous and avoid misinterpretation. In July 2013, the IASB welcomed comments on its Discussion Paper 'A Review of the Conceptual Framework for Financial Reporting'.

"The principle of prudence has been gradually eroded by the introduction of accounting standards that leave auditors with no recourse when they question a valuation," (the UK Shareholders' Association (UKSA), 2013). In support of its view, UKSA has urged the IASB to reconsider its position, correct the mistakes that have been made, and ensure that prudence is included in all future standards. On 13 May 2013, UKSA published a paper prepared by its members entitled "Prudence is missing"[46]. The UK used to have four fundamental accounting concepts, of which prudence was one – the paper states. "Prudence was the ultimate protection for investors, particularly private investors" such as those represented by the UK Shareholders' Association. They, by definition, do not have the resources of institutional investors to ferret out what may be imprudent assumptions in company accounts – the paper says. In the UKSA's view, prudence is no longer the underlying (fundamental) principle, as it once was (UKSA, 2013). "So, if the Framework is the foundation of its [IASB's] standards and it ignores prudence, how is it possible that the individual standards are still based on prudence? Either prudence is the basic attitude, or it is not, but the IASB's desire to have it both ways cannot be sustained" (UKSA, 2013)[47].

Earlier documents, for example, a UK FRC paper (2011) discussed that "the concept of prudence has evolved from the way it was applied in the UK GAAP before the adoption of FRS 18 *Accounting Policies*[48] – the greater emphasis on neutrality reflects a growing concern about the smoothing of profits. Similar considerations have led to changes in the IFRS conceptual framework to replace prudence with neutrality.[49] The FRC has joined forces with the European Financial Reporting Group (EFRAG) and as a result may have changed its position as expressed in a document, which states that it remains an open question whether the Framework (CF) should refer specifically to prudence and what exactly prudence means.[50]

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[46] UKSA (2013). "Prudence is missing", A paper prepared by the UK Shareholders' Association, 13 May 2013, London available at: https://www.uksa.org.uk/news/2013/05/14/prudence-missing
[47] Ibid.
[48] The accounting standard FRS 18 *Accounting Policies* set out requirements for the selection, application and disclosure of accounting policies. The Accounting Standards Board issued it in December 2000. This standard and all other old UK GAAP FRSs have been withdrawn for reporting periods starting on or after 1 January 2015. Topics within accounting policies, estimates and errors are covered by Section 10 of FRS 102 under the new UK GAAP, more detailed information available at: https://www.icaew.com/library/subject-gateways/accounting-standards/uk-frs/frs-18
[49] UK FRC paper of July 2011, signed on behalf of the Accounting Standards Board by Roger Marshall and on behalf of the
Auditing Practices Board by Richard Fleck.
[50] "Getting a better Framework: our strategy". EFRAG and others, January 2013.

Andrew M. Bauer, Patricia C. O'Brien, and Umar Saeed argue that "the IASB should reconsider its decisions on the concepts of reliability and prudence, to address the inherent accounting problem of moral hazard". The authors illustrate how reliability and prudence can help standard setters identify standards that can address moral hazard and the prevalence of moral hazard in the context of executive compensation arrangements.[51]

In January 2014, Richard Martin, Head of the corporate reporting department at the Association of Chartered Certified Accountants, described 'prudence' and 'accountability' as central to the Conceptual Framework. Richard Martin openly admitted that the situation was unsatisfactory because important aspects of accounting standard setting were missing.

The UK's Financial Reporting Council (UK FRC) has also been at the forefront of the efforts to restore 'prudence'. Giving evidence at a House of Lords Economic Affairs Committee hearing in 2014, FRC Chief Executive Stephen Haddrill admitted that the Council (FRC) has been lobbying hard to restore 'prudence' within the CF (Ram Subramanian, "Prudence gets a revival", 31 July 2014).

Nigel Sleigh-Johnson, Head of the Financial Reporting Faculty at the Institute of Chartered Accountants in England and Wales, discussed that some fundamental issues – "the nuts and bolts of financial reporting – shouldn't be overshadowed by the more controversial areas that have dominated the debate so far. For example, much attention will understandably be focused on areas such as prudence, stewardship and reliability" (Sleigh-Johnson, N., 2015).[52]

The European Financial Reporting Advisory Group (EFRAG), known as Europe's leading force influencing the development of IFRS, has prepared and published a feedback statement summarising the key observations and comments received on its public consultation paper in response to the IASB's *Exposure Draft ED/2015/3 Conceptual Framework for Financial Reporting* and explaining how these comments have been taken into account by EFRAG in its deliberations on its final comment letter. The purpose of the Discussion Paper was to obtain initial views and comments on the main issues that the IASB would consider in developing the Exposure Draft of a revised Conceptual Framework (ED). As some respondents considered that prudence would preclude the use of fair value, EFRAG stated in the comment letter that prudence should not (would not) preclude the use of fair value measurement, the recognition of fair value gains in appropriate circumstances, or the recognition of fair value gains in the financial statements. As primary users may have incompatible information needs, some respondents considered that the concept of prudence would be more closely aligned with the interests of creditors and long-term investors than with the interests of shareholders and short-term investors. In addition, one respondent considered that long-term investors should be specifically mentioned in the Conceptual Framework and that society as a whole should be considered as a 'user' of general purpose financial statements.

EFRAG highly appreciated the reintroduction of prudence in the IASB's Exposure Draft and agreed with the IASB's judgement expressed in the Basis for Conclusions (i.e. that prudence can lead to asymmetry in the recognition of assets/income and liabilities/expenses without introducing an undesirable bias in financial reporting) and, no less importantly, that prudence should not be subordinated to neutrality. The Conceptual Framework should focus on how prudence should influence standard setting rather than the behaviour of preparers.

EFRAG's consultation paper has been published. The document contains a separate section focusing on the comments on prudence, which were supported by a large number of respondents who fully agreed with the inclusion of an explicit reference to prudence in the CF. The ED's idea of including prudence in the description of neutrality was supported by some constituents for the following reasons: inclusion would ensure that prudence is not misused as a motive for systematic misstatement; prudence is necessary to achieve neutrality in financial reporting by counterbalancing management's inherently

[51] Bauer, Andrew M., O'Brien, Patricia C., and Umar Saeed (2014). "Reliability Makes Accounting Relevant: A Comment on the IASB Conceptual Framework Project", *Accounting in Europe*, July 2014, 11(2), pp. 211-217.
[52] Crump, R. (2015). "IASB restores the concept of prudence to financial reporting", *AccountancyAge*, May 29, 2015.

optimistic assumptions in making estimates; prudence is linked to neutrality because if management is prudent in its judgements and estimates under conditions of uncertainty, then management is neutral.

The 2010 Framework defined faithful representation as information that is complete, neutral, and free from error. The Basis for Conclusions in the 2010 Framework stated that prudence was not included because its inclusion would be inconsistent with neutrality. However, the removal of prudence led to confusion and criticisms, and many respondents to the IASB's Discussion Paper urged the IASB to reintroduce prudence. An explicit reference to prudence was therefore added, stating that "prudence is the exercise of caution in making judgements under conditions of uncertainty". The problem with tweaking the building blocks, even slightly, was that by adding the reference to prudence, the IASB encountered the further problem of asymmetry. Under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, which promotes a system of asymmetric prudence, a probable outflow of economic benefits would be recognized as a provision, whereas a probable inflow would only be shown as a contingent asset and disclosed in the financial statements. Therefore, two parties to the same legal dispute/litigation could have different accounting treatments even though the likelihood of a payout is the same for both parties. Many respondents highlighted the need for asymmetric prudence in some accounting standards and felt that the concept needed to be discussed. While this is true, the IASB believes that the Framework should not identify asymmetric prudence as a necessary feature of useful financial reporting. The IASB has tentatively decided to state that the concept of prudence does not imply the need for asymmetry, for example, the need for more persuasive evidence to support the recognition of assets than liabilities – in some cases such asymmetry may arise in accounting and financial reporting standards because of the requirement for the most useful information.

The main reasons for the revival of prudence, perceived as a concept in the UK and as a principle in continental European countries, are as follows:

• Prudence embodies both existing and proposed IAS/IFRS and it is therefore important that its meaning is defined as clearly as possible in the CF so that the prescribed rules can be applied consistently;

• Accountants call for prudence requirements in the preparation of financial statements to counter the natural bias of management towards optimism that influences this process;

• Prudence helps to address the greater concern of investors, which is concern about downside risk rather than upside potential;

• The application of prudence helps to align and support the interests of both shareholders and managers and can therefore reduce moral hazard;

• Research by academics suggests that 'conditional conservatism' (defined as the more timely recognition of losses than gains) plays an important role in financial reporting;

• The need for "prudence" in the estimation process has been demonstrated by the recent global crises.

Those who argue against the reintroduction of prudence have given reasons:

• A lack of clear understanding of the concept could lead to different interpretations and inconsistent application in practice, which could affect comparability;

• The application of prudence could lead to bias in financial statements, which 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 so-called "reverse effect");

• The IASB's previous decision to remove prudence from the CF was subject to extensive due process and agreed with the US Financial Accounting Standards Board (US FASB), so reintroducing prudence could also mean diverging from the approach used by the FASB.

Ian Mackintosh, former Vice-Chair of the International Accounting Standards Board (IASB)[53], has admitted that the US Financial Accounting Standards Board (FASB) exerted influence on IASB members at the time. "I didn't think it [prudence] should have been taken out. But there were people who thought it conflicted with neutrality[54]. There are still people who think that way. But I don't" (Ian Mackintosh, 2015). Mackintosh went on to acknowledge that "the influence of the US Financial Accounting Standards Board (FASB) is not as strong as it used to be" (ICAEW Economia, 2015[55]). Mackintosh acknowledged (2015) that "when prudence was taken out, the concepts were being developed jointly [collaboratively]. The US did not have it and did not see why it should be in there so that probably influenced the IASB at the time. After the Framework became an IASB-only project, a door was opened for prudence to come back through" (Mackintosh, 2015, quoted by Lesley Meall). When asked why it was worth bothering to bring prudence back into the framework (CF), Mackintosh explained that prudence gives people some comfort, arguing that some investors equate prudence with a "true and fair view" because they believe it gives auditors a tool to counterbalance management's optimism and aggressive accounting policies.

In May 2014, the IASB tentatively decided to reintroduce a reference to prudence in the CF, which was then under revision. We were particularly interested in the new definition of prudence – the exercise of caution in making judgements under conditions of uncertainty. It was finally recognized that prudence is consistent with neutrality and should not allow assets, liabilities, income, or expenses to be overstated or understated in the preparation of financial statements. It is easy to find an argument to support the view or decision to change the definition of prudence and it was necessary to do so. The argument is that the understatement of assets today may lead to the recognition of lower costs or expenses tomorrow, a little later in the current period, or in the short, medium, or long term, which may result in artificially exaggerated profits/income or understated losses. Conversely, the overstatement of liabilities or some expenses today may lead to the recognition of overstated revenues, i.e., overstated profits/income or understated losses, later. If we deliberately overstate assets and/or income today, we will most likely be forced to understate some liabilities and/or expenses in the future in order to avoid turning past overstatements of gains/income into current losses.

On 18 May 2016, at the IASB meeting, the Board confirmed its previous decision and belief that the Exposure Draft should propose reintroducing an explicit reference to the notion of prudence. However, again after lengthy persuasion, the Board acknowledged that neutrality is supported by the exercise of prudence. This is my thesis and my view, which I have been arguing for since the beginning of the debate, since the debate itself (Oreshkova, H., 2012, 2013, 2014, 2015, 2016, 2017, pp. 343-380)[56].

In the Conceptual Framework issued in 2018, Chapter 2 'Qualitative characteristics of useful financial information', the IASB has reintroduced an explicit reference to prudence, stating that *the exercise of prudence supports neutrality. Prudence is defined as "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***

[53] Ian Mackintosh has distinguished career in national and international standardisation spanned decades. Chair of IFAC's Public Sector Committee (PSC) prior to its formal establishment as the International Public Sector Accounting Standards Board (IPSASB). Deputy Chairman of the Australian Accounting Standards Board, Chairman of the Australian Public Sector Accounting Standards Board and Chief Accountant of the Australian Securities and Investments Commission. Most recently, Ian was Chairman of the Corporate Reporting Dialogue from 2017 to 2021, where he played a fundamental role in laying the foundations for the consolidation of the disclosure landscape. The Corporate Reporting Dialogue brought together the leading corporate reporting organisations to discuss alignment and consolidation and ultimately achieved its objectives when four of its seven members consolidated under the IFRS Foundation in 2022.

[54] Prudence seems to be inherently inconsistent with neutrality, so prudence cannot be included in this concept. This is ACCA's view, and we strongly disagree.

[55] http://economia.icaew.com/en/features/july-2015/perspective-on-prudence

[56] Oreshkova, H. (2017). "The Debate on Prudence in Accounting", *Journal of CBU*, Volume 5 (2017): *CBU International Conference Proceedings* 2017, pp. 343-380 *[Indexed in Web of Science]*, CBU International Conference, 22-24 March 2017, Prague, Czech Republic.

or income or the overstatement of liabilities or expenses," (paragraph 2.16)[57]. In my research on this issue, I discussed the reasoning behind this change in defining prudence (Oreshkova, 2014, p. 282). The idea is that in future periods such misstatements may lead to the overstatement or understatement of income/profits or expenses/losses. In addition, in paragraph 2.17 it is added: *"The exercise of prudence does not imply a need for asymmetry, for example, a systematic need for more persuasive evidence to support the recognition of assets or income than the recognition of liabilities or expenses. Such asymmetry is not [considered by the Board to be] a qualitative characteristic of useful financial information. Nevertheless, particular Standards may contain asymmetric requirements [the Board considers this to be acceptable] if this is a consequence of decisions intended to select the most relevant information that faithfully represents what it purports to represent."*[58]

Leading professional institutions such as the members of ICAEW's Financial Reporting Faculty and their supporters were very pleased to see prudence back in the CF. Others were not, particularly those who see a tension between prudence and the concept of neutrality, which I believe does not exist and is artificially inflated. Professor Fearnley challenged the opponents, commenting: "What is neutrality? It is rubbish. Accounts can never be neutral because there are so many judgements in them". ACCA members believe that "As prudence is apparently reflected in the standards, it seems right that its role is [should be] discussed in the framework that is used to set those standards"[59].

In my view, in some professional circles "neutrality" is mostly interpreted as "lack of bias" as stated in the 2010 CF, and it has been prioritized and given precedence over "prudence", which is fueling the controversy. However, these people misinterpret "prudence", because prudence does not mean "bias", or "deliberate bias", nor does it mean "big bath" accounting. The biased misrepresentation of the values of elements of the financial statements, when the facts and values are not difficult to ascertain, should not be regarded as conservatism or prudence, but simply as concealment or deliberate non-disclosure of data, which, in turn, may be misleading, and this is neither a prudent nor a conservative approach. "Conservatism is a genuine, prudent response to uncertainty, whereas the "big bath" accounting is a deliberate attempt to mislead the users of financial statements when there is, in fact, no uncertainty" (Paton, 1916). As early as 1916, W. A. Paton pointed out *"a sheer understatement where it is possible to ascertain the actual facts is not conservatism but concealment"* (Paton, 1916, p. 237).

My previous research discusses how academic and historical evidence confirms that conservatism is one of the oldest and most important accounting principles (Sterling, 1967; Watts, 2003a)[60]. Many researchers have noted that it has been problematic to fully incorporate conservatism into the normative accounting theory. Conservatism was a primary principle for the German proponents of the balance sheet approach, known as the 'statists' (Forrester, 1993, Chapter V). From 1908 onwards, a different view and an income statement approach to profit or loss was advocated (the dynamic theory of the world famous German theorist Eugen Schmalenbach, 1959, and Quire, 1965, which emphasized the "matching of flows of production and consumption in order to measure profit"). A key issue raised by Eugen Schmalenbach is which of the two – overstated or understated income is more misleading and therefore risky. Although Schmalenbach disagreed with the static theory, he agreed with the 'statists' with regard to the primary role of conservatism. Schmalenbach (1959, p. 82) argued that *an overstated profit is far more dangerous than an understated one*. At the same time, however, Schmalenbach (1959) admitted that conservatism could be exaggerated and suggested that understatement of profits could be harmful (quoted by Hellman, 2008, p. 74). In Hellman's particular words, it is not clear-cut from reading Schmalenbach (1959) how the appropriate level of conservatism should be determined. We would then recall that leading professional bodies such as ACCA argue that "it is certainly where profits and assets have been overstated – not where

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[57] IFRS Foundation IASB Conceptual Framework for Financial Reporting, March 2018, p. 16, p. 84. Assets, liabilities, income and expenses are defined in Table 4.1 of the CF. They are the elements of financial statements.
[58] Ibid.
[59] The Association of Chartered Certified Accountants (ACCA) 2014. "Prudence and IFRS", The Association of Chartered Certified Accountants, August 2014, London.
[60] See Oreshkova, H. (2017). "The Debate on Prudence in Accounting", *Journal of CBUIC*, Volume 5 (2017), p. 348.

they have been understated – that accounts, accountants, and accounting standards have received the most criticism”[61].

The hypothesis of the use of the “hidden reserves” system, which has been discussed in debates focusing on accounting conservatism, has been discussed in my previous research[62] [63]. The problem has been raised and, in my view, exaggerated by opponents who claim to be against “prudence” or “conservatism” in accounting and who appear to be advocates of the “true and fair view” or “fair presentation” postulate. In the literature, the issue of “hidden reserves” is discussed in terms of the possible effects of the accounting policy (choice) and application of a particular approach, model or rule of initial or subsequent valuation on the carrying value of (net) assets and income.

The essential issues concerning “prudence” should be discussed straightforwardly, without prejudice or manipulation, and without forgetting the rationality that traditional (conventional) prudence embodies. We are confident that the resilience of prudence to criticism over the centuries is due to its fundamental nature as a core principle and its crucial role in accounting as a trinity of theory, methodology, and social practice.

There is an important point to bear in mind. In my opinion, it is very important to stress that a distinction should be made between two cases: the first case is when the creation of hidden reserves is done systematically, deliberately, i.e. when one is not faced with any kind of uncertainty and can easily ascertain the actual facts or values; the second case is when hidden reserves are not created deliberately, but accidentally, unintentionally, involuntarily, in the absence of any deliberate action, i.e. when one is faced with any kind of uncertainty or unknown magnitudes. In my opinion, the deliberate creation of hidden reserves is wrongly equated with “conservatism”; they appear to be similar, but only superficially; such an interpretation implies a superficial view of the problem; however, there is a line that helps to distinguish between the two types of behaviour of accountants. Following this line of thought, it is appropriate at this point to support our argument with Paton and Stevenson's understanding, which I believe to be entirely correct and true. As early as 1916, W. A. Paton pointed out that “a sheer understatement where it is possible to ascertain the actual facts is not conservatism but concealment” (Paton, 1916, p. 237).

Watts (2003a; 2003b) has noted that, despite criticism, accounting conservatism has not only survived numerous accounting reforms, regulations and economic crises over the past century, but that the average level of accounting conservatism, at least in the US, has even (slightly) increased over the past 30 years (Oreshkova, pp. 277-290). This assertion has been confirmed by empirical studies based on large samples of data from the US and worldwide. For example, the renowned historian Parker observes of the lower of cost or market value rule, “The astonishing thing about the lower of cost or market rule is its ability to survive attack. G. O. May was probably right in suggesting that most accountants are ‘content to regard the demonstrated practical wisdom of the rule as outweighing any supposed illogicality’,”[64] (Parker, R.,1969, p. 257, quoted by Wang, R., 2009, p. 13[65]). The apparent resilience of conservatism in accounting

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[61] The Association of Chartered Certified Accountants (ACCA) 2014. “Prudence and IFRS” prepared by the Association of Chartered Certified Accountants, August 2014, London.

[62] See Oreshkova, H. (2016). “The Rush towards Erosion of “Prudence” in Accounting (Are the Accounting Standard Setters Concerned with the Views of Academics or Is It Just a Rhetorical Question)” in *Proceedings of the 11th International Conference* ‘Accounting and Management Information Systems’, pp. 171-189 *[Indexed in Web of Science]*, AMIS 2016 International Conference, The Bucharest University of Economic Studies, Bucharest, Romania.

[63] See Oreshkova, H. (2017). “The Debate on Prudence in Accounting”, *Journal of CBUIC*, Volume 5 (2017), pp. 343-380. See Oreshkova, H. (2018). The Revival of Prudence in Accounting – Truth or Illusion (After the Long-lasting Erosion), *Knowledge International Journal*, 23(4), pp. 1005–1019.

[64] Parker, R. H. (1969). Readings in the concept and measurement of income, edited with an introduction by R. H. Parker and G. C. Harcourt, pp. 239–258. London, Cambridge University Press.

[65] Wang, R. Z. (2009). Accounting conservatism, A Thesis for the Degree of Doctor of Philosophy in Accounting, pp. 1-198, Victoria University of Wellington.

over time has been explained by Watts in terms of litigation risk, debt contracts, management contracts, political costs, and tax incentives (2003a, pp. 207-221)[66].

An essential argument put forward by proponents is that 'prudence' or 'conservatism' serves the needs of creditors well. With specific reference to the German accounting system, Haller (2003, p. 92)[67] [68]states that the principle of conservatism is not understood as a sub-characteristic, as it is in the US and the UK, but rather as the core principle of accounting, which logically follows from the objective of creditor protection (by Hellman, 2008, p. 72)[69]. However, Sterling (1967) argues that conservatism has historically been one of the most influential accounting principles even in the USA, where companies to a greater extent turn to the stock market for financing. It should be noted here that conservatism also serves many other stakeholders, such as potential and current investors, employees and other workers, government institutions, as well as the social interests of all members of society and society as a whole because of its social significance and the positive social implications of its consistent application.

CONCLUSION

Based on my research and long observation of the dynamically evolving regulatory process, I would argue that the EU accounting standard setter, as a supranational body that develops accounting standards for many large companies operating in the EU and elsewhere, is responsible for some ambiguities or at least misunderstandings or confusion, by virtue of its prerogatives. Over the years, the EU standard setter has been inconsistent in its policy of caution. A major reason for this is probably the impact of political, institutional, and other factors affecting the global convergence process. The developments and deliberations in December 2016, January and February 2017, and the first quarter of 2018, which focused on the final content of the CF, have confirmed this once again.

The research and literature on conservatism and prudence is extensive. Prudence, whether seen as an overriding principle, a theoretical concept, a convention, or something else, should have been, and has been, reintroduced into financial reporting as part of the long-awaited revision of the Conceptual Framework, as the Framework underpins the setting of international accounting rules and financial reporting. Prudence was to be restored in the revised CF (originally expected in 2016 or much earlier), and I believe there was no alternative. The CF would have been incomplete without prudence – the absence of prudence (would) allow company directors or other officials (under the influence of stakeholders and other interested parties, or not) to selectively choose asset valuations for accounting and financial reporting purposes from approved range, even if accountants or auditors, or both, consider the choice to be imprudent. International accounting standards are essential. Standards must be of high quality and based on fundamental principles, including prudence. In addition, it is desirable rather than achievable that the standards are consistent with other related legislation, but this is a highly complex issue. The IAS/IFRS standards issued by the IASB are used in over 168 jurisdictions. The UK Companies Act requires accounts to give a "true and fair view". It is therefore logical that the international accounting standards allow for professional judgements to ensure that they adequately meet the overarching legal requirement set out in the UK Companies Act. However, the situation is more complex in countries of continental European law.

After more than eight years of hard work to revise and significantly improve the quality of the Conceptual Framework, the members of the International Accounting Standards Board issued a new CF in March 2018, restoring the reference to prudence. Influential representatives of the world's most

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[66] Watts, R.L., (2003a). Conservatism in accounting Part I: Explanations and implications. Accounting Horizons, 17 (3), 207–221.

[67] Haller, A. and Eierle, B. (2004). "The adoption of German accounting rules to IFRS: a legislative balancing act", *Accounting in Europe*, 1(1), pp. 27-50.

[68] Haller, A. (2003). Accounting in Germany in: P. Walton, A. Haller and B. Raffournier (Editions) International Accounting, 2nd edition (Thomson Learning).

[69] Hellman, N. (2008). Accounting Conservatism under IFRS. Accounting in Europe, Vol. 5, No. 2, pp. 71-100.

prominent stakeholder communities of academics, professional bodies, experts, accountants, and other professionals exerted great pressure, but this does not mean that conflicting academic views on prudence will reach a point of consensus.

The primary purpose of the Conceptual Framework is to support the credibility of international financial reporting and the information it provides. Therefore, the Conceptual Framework must be of high quality, which the authoritative members of the International Accounting Standards Board of the IFRS Foundation must achieve, which I consider to be one of their priorities and a fundamental role. The Conceptual Framework underpins the IFRS issued by the IASB. This means that the Conceptual Framework is the EU constitutional basis for IFRS. IFRS must therefore be based on the same principles as the Conceptual Framework.

Transparency based on prudence, optimally combined with caution, should be a priority in financial reporting and presentation, as well as in the disclosure of material financial and non-financial information, both historical and prospective. To this end, the approaches, models, and rules for recognizing and measuring assets, liabilities, and components of capital, costs, and revenues need to be developed and implemented in the spirit of this sound philosophy. Much remains to be done to restore confidence in the quality of corporate reporting and the information it provides to the public. We need to rebuild trust in the institutions and people responsible for their credibility and oversight.

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