POLICY PAPER

A(NOTHER) LOOK AT PRUDENCE/CONSERVATISM IN FRAMEWORKS, IN STANDARDS, IN PRACTICE AND IN ACADEMIA

Paul André & Andrei Filip - ESSEC Business School

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1. PREAMBLE

Only examining a setting for the consolidated financial statements of non-financial listed firms, other settings generating their own debates:

- Even though IFRS apply equally to financial and non financial firms, we believe that they are quite different in nature.
- Non-consolidated financial statements serve very different purpose.
- Private firms may have very different uses for financial statements.

The *Conceptual Framework for Financial Reporting* (the '*Conceptual Framework*') describes the objective of, and the concepts for, general purpose financial reporting. It is a practical tool that:

- (a) assists the International Accounting Standards Board (IASB) to develop Standards that are based on consistent concepts;
- (b) assists preparers to develop consistent accounting policies when no Standard applies to a particular transaction or event, or when a Standard allows a choice of accounting policy; and
- (c) assists others to understand and interpret the Standards.

Recall the IFRS Foundation's main objective:

- to develop, in the public interest, a single set of high quality, understandable, enforceable and globally accepted financial reporting standards based upon clearly articulated principles. These standards should require high quality, transparent and comparable information in financial statements and other financial reporting to help investors, other participants in the world's capital markets and other users of financial information make economic decisions. (IFRS Foundation Constitution par. 2a)

Difficult to discuss one characteristic by itself since 1) qualitative characteristics are supposed to follow from the objectives, and with the definition of financial statement components should clarify recognition, measurement and disclosure issues; 2) number of qualitative characteristics have historically been closely linked.

The following can be viewed as a survey of surveys, the topic having generated many papers including recent surveys by Barker & McGeachin (2015), Mora & Walker (2015) and Ruch and Taylor (2014).

2. SUMMARY

The concept of prudence remains controversial in accounting practice, standard setting and academia.

For one, there is no generally accepted definition leading to similar or dissimilar uses of the word prudence, conservatism or caution:

- One reason for such disagreement is different desired objectives of financial reporting.
- A second is that we can have varying potential levels of prudence/conservatism with respect to 1) dealing with uncertainty; 2) recognizing and measuring assets and liabilities; 3) measuring profits; 4) determining optimal disclosures.
- A third is that academics have developed proxies for various forms of conservatism (conditional and unconditional) which do not always translate well into practice/standard setting.

There is a long history, pre-CF, of having conservative practices, mostly 'lower of cost and market' rules. These would appear to have been in response to 1) high taxes; 2) periods of numerous company failures and required liquidations; 3) fraudulent accounting used to attract equity capital. Also, this was viewed as a way of countering the inherent optimism of entrepreneurs.

- While prudence might be justified when accounting is mainly used for tax purposes, dividend distribution or liquidations, these are not the primary objectives of consolidated financial statements produced by publicly listed firms using IFRS. This does led to an issue about differential demand for conservatism between small and large firms… (Thornton, 2015).

One of the endless tensions with respect to the objectives of financial statements is the following: can general purpose financial statements under one set of GAAP serve both the purpose of helping in forecasting future cash flows (or reducing the adverse selection problem) and the stewardship/contracting role (or reducing moral hazard). Some argue that financial reports cannot serve both objectives whereas others argue that prudent accounting principles for stewardship can also reduce adverse selection.

What about the IASB?

- Old CF (pre 2010) had a place for prudence and stewardship, although limited.
- Revised 2010 CF dropped both stewardship and prudence. Note that some argue that IAS1/IFRS1 still referred to old CF so that the 2010 never really applied (Nobes, 2015). Nobes also argues that the belief that this lead to more fair value (FV) is a myth, at least for non-financial firms. Further, conservatism and historical cost (HC) are not necessarily interlinked (Mora and Walker 2015).
- We argue that IFRS have eliminated some bad conservatism (unconditional, in fact cookie jar reserves, i.e. earnings management) but not all (e.g. most internally generated intangibles not booked) and still has lots of good (conditional) conservatism with some greater emphasis on impairment since adopting IFRS 3 and revised IAS 36 and 38. Barker and McGeachin (2015) suggest that IFRSs are conservative but this is not recognized in the 2010 CF (or the proposed new CF). Hoogervorst (speech 2012) talking about the continued place of prudence in IFRS

(some would say beyond simply applying caution) in a way recognizes this. Some argue that dropping prudence may have serve mostly to counter and tradition of excessive conservatism (cookie-jar accounting) present in many local GAAP.

Many (both academics, regulators and standard setter) suggest, as we do, that part of the problem is maybe not the standards but a fundamental issue with one of the most important manifestations of prudence: impairment tests. Earnings management and conservatism maybe linked because of timing of impairments and big bath behaviour. Standards by themselves may not be effective without adequate enforcement.

Ball, Li, and Shivakumar (2013), however, present worrying results that IFRS may have led to more 'frozen IFRS' or tailored accounting principles (TAP) in debt contracts which may have increased cost of contracting. Is it a lack of prudence (some would say more FVA) or significant changes to IFRS in the 2005-2015 window that explains these results? If so, should costs benefits analysis be more important in standard setting? Basu (2009) furthers: 'Put differently, if conditional conservatism improves contracting efficiency but is not permitted, how do firms and their stakeholders improve their contracting efficiency? Is it by increased disclosure, posting deposits or other bonding devices, getting political or regulatory backing, or some other mechanism? Does the introduction of conditional conservatism reduce reliance on these alternative contracting mechanisms (are they substitutes) or increase reliance on them (are they complements)? More generally, if mandatory unconditional conservatism preempts conditional conservatism (eg R&D accounting in the U.S.), how do affected firms improve their contracting efficiency to compete with unaffected firms?'

Mora and Walker (2015) conclude that the value of accounting conservatism is likely to vary across countries and across firms. It is not safe to assume that either *neutral* or *conservative* financial reporting will be the best form of accounting for all types of firms and for all national contexts. Accounting standards should be framed in a way that will allow firms to explicitly pre-commit to conditionally conservative accounting practices or to neutral accounting practices according to the financial reporting needs of the firm. Financial reporting standards that force all firms to adopt neutral or conservative accounting practices run the risk of causing more harm than good. In addition we would like to see the conceptual framework expanded to explicitly acknowledge the importance of moral hazard and adverse selection as fundamental features of the economic system.

As we discuss in the conclusion, proposed new CF does reintroduce the objective of stewardship and prudence, like it was pre 2010 but not exactly (now more clearly associated to neutrality rather than reliability!) and not obvious this resolves the controversy. Also recognizes that impairment test and write-offs can respect concepts of neutrality and faithful representation (not wanting to call this conservatism/prudence/timely recognition of losses)! Remain some logical inconsistencies in the proposed new CF. Not obvious that proposed changes will satisfy most users and preparers which are looking for a broader use of the prudence concept without reverting back to hidden reserves or cookie jar accounting.

3. PRUDENCE IN PRACTICE (PRE CONCEPTUAL FRAMEWORK)

"Recognize all losses, but anticipate no gains"
(Gilman 1939, 130–131 and 232–236_in Dickhaut et al. 2010)

Some view that our brains are wired to be **prudent**, prudence facilitates the building of trust between parties, thus exchanges that have been necessary in human survival over time (Dickhaut, Basu, McCabe, & Waymire, 2010). The authors suggest that the ultimate explanation for the **conservatism** principle may derive from how gains and losses are differentially processed by neurons within the human brain. Humans weight losses more heavily (think of the demand for insurance). So, **conservatism** limits the overstatement of net assets and income and constrains decisions that could harm one's reputation in a multi-period world.

Watts (2003) argues that **conservatism** is an important feature of financial reporting in ensuring efficient contracting between shareholders and debt holders and between shareholders and managers by limiting managerial bias and the risk of opportunistic payments (e.g., compensation, dividends); in reducing the risk of litigation; in reducing the present value of taxes and in reducing the political costs to regulators of firms overstating net assets. Kothari, Ramanna, and Skinner (2010) further argue that the demand for credible financial information from shareholders and debt holders leads to conservatism.

The use of lower of cost and market (LCM) is probably the first documented practice of conservatism known. Littleton (1941) examines various writings of authors having examine 'old' records and finds the use of LCM as early as the beginning of the 15th century, nearly 100 years before publication of Pacioli's text on double-entry bookkeeping. Savary (1675) is often cited as the first author to suggest LCM in his 'Le Parfait Négociant' but without a formal justification. He concludes that the use of LCM in Italy was mainly to limit taxes paid and that in France and Germany to lower the opportunity for fraud. (Vance, 1943) indicates that LCM was required in Prussia from 1794 and under German Commercial Code as of 1873. He believes that prudence not only for tax or regulatory reasons but to help business people measure periodic performance.

Parker (1965) question how much these would have impacted modern accounting practice. Nevertheless, he notes that the UK profession developed end of 19th century at a time of numerous bankruptcies and falling prices; a potential explanation for conservatism. The US has longer tradition of academic accounting (starting with Wharton, the first business school), already debating these issues.

'*Uniform Accounting for Bank Borrowers*', a bulletin published by the Federal Reserve Bank in 1917 is sometimes viewed as the first authoritative advice on accounting practice (Zeff, 2013) It has a number of examples of LCM rules:

> "-Where the market values of securities are less than the book values, save where the variation is so small as to be trifling, a reserve for loss in value on the balance sheet date must be set up.
> - The auditor should satisfy himself that inventories are stated at cost or market prices, whichever are the lower at the date of the balance sheet. No inventory must be passed which has been marked up to market prices and a profit assumed that is not and may never

be realized. If the market is higher than cost it is permissible to state that fact in a footnote on the balance sheet."

Bliss' (1924, p. 110) textbook 'Management through accounts' states the following:

> 'The old and **conservative** rule of accounting and business practice is to anticipate no profits and provide for all probable losses. No sounder advice for business conduct has been written. While at first thought this might be considered as a comment on the preparation of profit and loss statements, it has a most direct bearing on the preparation of balance sheets. Anticipation of profits, or taking account of gains not yet realized, not only swells the results shown by the profit and loss account, but overstates the financial position as shown by the balance sheet. Unrealized or anticipated profits must of necessity appear in some asset account in the balance sheet. In the same manner failure to provide for all probable losses not only overstates the real profits as shown in the profit and loss account, but also gives an inflated value to some asset or omits some liability from the balance sheet, and consequently impairs the integrity of that statement. The balance sheet of a business, whether prepared on a going concern basis or on a liquidating basis, should conform fully to the principles of this maxim; for such it has come to be.'

He continues as follows (p. 110-111):

> 'The preparation of a balance sheet on a going-concern basis contemplates including all assets of the business at **conservative** but full and fair values to the business as a going-concern. It means valuing:
>
> -Inventories at cost or market, whichever is lower, market being the current market for sales, less costs and expenses yet to be incurred.
>
> -Accounts receivable at realizable values to the business as a going-concern.
>
> -Prepaid expenses and deferred charges at cost, which is their value to a going-concern.
>
> -Fixed property investments at cost or conservative appraisal values to that concern as a going business.
>
> -Intangible fixed investments —goodwill, patents, copyrights, etc. — at cost, less any sums properly amortized.
>
> and it contemplates offsetting against these assets all determined liabilities at full amounts and properly classified, with appropriate mention of undetermined or contingent liabilities.'

It would seem that prudence a prevalent concept even before formal attempts to create a framework. The genesis for a search for principles begins mostly after the Great Crash and Crisis, again encouraging conservatism. First 'rules' developed by American Institute of CPA in 1932 and 1934 (Parker, 1965) stated realization as its first principle and notes that best practice for inventories is lower of cost or market. Sanders, Hatfield and Moore (1938) sixth 'great principles':

The possible extent of unforeseen contingencies of adverse character calls for a generally conservative treatment of items to which judgment must be applied.[52]

> Only income realized by the sale of goods or rendering of service is to be shown in the income statement. Unrealized income should not be recorded,[53] nor utilized to absorb proper charges against earnings. . . . Cost and expenses must include . . . inventory losses of the period. . . . The proper showing of current assets requires . . . that the values in general be the lowest of cost, replacement, or realization, as may be applicable for the several items. . . .[54]

The 'A Tentative Statement of Accounting Principles affecting Corporate Reports of 1936 (also repeated in 1941 and 1948) was more based on new doctrine of recoverable cost rather than conservatism per se:

> Every business enterprise should eliminate from its accounts those costs which are applicable to assets no longer useful or salable, and should reduce the carrying values of assets in use or ultimately to be marketed to such amounts as may reasonably be expected to be recoverable in the course of future operations.[59]

ARB 29 (1947) states:

> A departure from the cost basis . . . is required when the utility of the goods is no longer as great as its cost. Where there is evidence that the utility of the goods, in their disposal in the ordinary course of business, will be less than cost, whether due to physical deterioration, obsolescence, changes in price levels, or other causes, the difference should be recognized as a loss of the current period. This is generally accomplished by stating such goods at a lower level commonly designated as *market*.[70]

So recoverable cost doctrine allows illogical pairing of two rival concepts of cost and value! This appears to not have been challenged in the UK either.

It must be noted that conservatism and LCM were not without critics. Paton and Stevenson (1920, 476) note: "As a matter of fact, such a principle [lower-of-cost-or-market] does not insure conservatism. Instead, conservatism is enforced only by sound reasoning, integrity, and governmental regulation". Zeff (2013) notes that conservatism was the '*bête noire* to some leading US accounting academics, especially because of the 'lower of cost or market' method for valuing merchandise inventories (Paton 1922, p. 446; Hatfield 1927, p. 274; Gilman 1939, p. 235; Paton and Littleton 1940, p. 81; Sterling 1967)'. It should be noted that the predecessors to the FASB's conceptual framework, *A Statement of Basic Accounting Theory* (ASOBAT) (AAA, 1966) and the Trueblood report (1973) did not envision a role for conservatism.

4. PRUDENCE IN THE US AND IASB CONCEPTUAL FRAMEWORKS

(a) *Introduction*

We briefly present the place of prudence in the different US and IASB conceptual frameworks as of the 1970s.

(b) *US*

Statement 4 The Basic Concepts of Accounting Principles Underlying Financial Statements of Business Enterprises APB (1970)

In APB no. 4 issued in 1970 in the US it was stated that:

28. Pervasive principles (Chapter 6) form the basis for much of the accounting process. They include pervasive measurement principles and modifying conventions. The pervasive measurement principles—for example, realization—broadly determine the events recognized in financial accounting, the basis of measurement used in financial accounting, and the way net income is determined. The modifying conventions—for example, **conservatism**—affect the application of the pervasive measurement principles.

35. Some of the more important present characteristics and limitations of financial accounting and financial statements are briefly described.
...
Conservatism. The uncertainties that surround the preparation of financial statements are reflected in a general tendency toward early recognition of unfavorable events and minimization of the amount of net assets and net income.

PERVASIVE PRINCIPLES
143. The pervasive principles specify the general approach accountants take to recognition and measurement of events that affect the financial position and results of operations of enterprises. The pervasive principles are divided into (1) pervasive measurement principles and (2) modifying conventions.

169. The pervasive measurement principles are largely practical responses to problems of measurement in financial accounting and do not provide results that are considered satisfactory in all circumstances. Certain widely adopted conventions modify the application of the pervasive measurement principles. These modifying conventions, discussed in the following paragraphs, have evolved to deal with some of the most difficult and controversial problem areas in financial accounting.

170. The modifying conventions are applied through generally accepted rules that are expressed either in the broad operating principles or in the detailed principles. The modifying conventions are a means of substituting the collective judgment of the profession for that of the individual accountant.

171. Frequently, assets and liabilities are measured in a context of significant uncertainties. Historically, managers, investors, and accountants have generally preferred possible errors in measurement to be in the direction of understatement of net income and net assets. This had

led to the convention of **conservatism**, which is expressed in rules adopted by the profession as a whole such as the rules that inventory should be measured at the lower of cost and market and that accrued net losses should be recognized on firm purchase commitments for goods for inventory. These rules may result in stating net income and net assets at amounts lower than would otherwise result from applying the pervasive measurement principles.

SFAC #2 Qualitative Characteristics of Accounting Information, FASB, May 1980

Conservatism (Glossary)
A prudent reaction to uncertainty to try to ensure that uncertainty and risks inherent in business situations are adequately considered.

Conservatism

91. Nothing has yet been said about **conservatism**, a convention that many accountants believe to be appropriate in making accounting decisions. To quote APB Statement 4: Frequently, assets and liabilities are measured in a context of significant uncertainties. Historically, managers, investors, and accountants have generally preferred that possible errors in measurement be in the direction of understatement rather than overstatement of net income and net assets. This has led to the convention of **conservatism**. . . [paragraph 171].

92. There is a place for a convention such as **conservatism**—meaning **prudence**—in financial accounting and reporting, because business and economic activities are surrounded by uncertainty, but it needs to be applied with care. Since a preference "that possible errors in measurement be in the direction of understatement rather than overstatement of net income and net assets" introduces a bias into financial reporting, conservatism tends to conflict with significant qualitative characteristics, such as representational faithfulness, neutrality, and comparability (including consistency). To be clear about what **conservatism** does not mean may often be as important as to be clear about what it means.

93. **Conservatism** in financial reporting should no longer connote deliberate, consistent understatement of net assets and profits. The Board emphasizes that point because **conservatism** has long been identified with the idea that deliberate understatement is a virtue. That notion became deeply ingrained and is still in evidence despite efforts over the past 40 years to change it. The convention of **conservatism**, which was once commonly expressed in the admonition to "anticipate no profits but anticipate all losses," developed during a time when balance sheets were considered the primary (and often only) financial statement, and details of profits or other operating results were rarely provided outside business enterprises. To the bankers or other lenders who were the principal external users of financial statements, understatement for its own sake became widely considered to be desirable, since the greater the understatement of assets the greater the margin of safety the assets provided as security for loans or other debts.

94. Once the practice of providing information about periodic income as well as balance sheets became common, however, it also became evident that understated assets frequently led to overstated income in later periods. Perceptive accountants saw that consistent understatement was difficult to maintain over a lengthy period, and the Committee on Accounting Procedure began to say so, for example, in ARB No. 3, *Quasi-Reorganization or Corporate Readjustment—*

Amplification of Institute Rule No. 2 of 1934: "Understatement as at the effective date of the readjustment of assets which are likely to be realized thereafter, though it may result in **conservatism** in the balance-sheet, may also result in overstatement of earnings or of earned surplus when the assets are subsequently realized. Therefore, in general, assets should be carried forward as of the date of readjustment at a fair and not unduly **conservative** value."

The Committee also formulated the "cost or market rule" in ARB No. 29, *Inventory Pricing,* in such a way that decreases in replacement costs do not result in writing down inventory unless (a) the expected selling price also decreases or (b) costs to complete and sell inventory increase; unless those conditions are met, recognition of a loss by writing down inventory merely increases income in one or more later periods. (ARB 3 and 29 became, respectively, chapters 7A and 4 of ARB No. 43, *Restatement and Revision of Accounting Research Bulletins*). Among the most recent admonitions on the point is that of the International Accounting Standards Committee (IASC) in International Accounting Standard No. 1, *Disclosure of Accounting Policies*: "Uncertainties inevitably surround many transactions. This should be recognized by exercising **prudence** in preparing financial statements. **Prudence** does not, however, justify the creation of secret or hidden reserves."

95. **Conservatism** is a prudent reaction to uncertainty to try to ensure that uncertainties and risks inherent in business situations are adequately considered. Thus, if two estimates of amounts to be received or paid in the future are about equally likely, **conservatism** dictates using the less optimistic estimate; however, if two amounts are not equally likely, **conservatism** does not necessarily dictate using the more pessimistic amount rather than the more likely one. **Conservatism** no longer requires deferring recognition of income beyond the time that adequate evidence of its existence becomes available or justifies recognizing losses before there is adequate evidence that they have been incurred.

96. The Board emphasizes that any attempt to understate results consistently is likely to raise questions about the reliability and the integrity of information about those results and will probably be self-defeating in the long run. That kind of reporting, however well-intentioned, is not consistent with the desirable characteristics described in this Statement. On the other hand, the Board also emphasizes that **imprudent** reporting, such as may be reflected, for example, in overly optimistic estimates of realization, is certainly no less inconsistent with those characteristics. Bias in estimating components of earnings, whether overly **conservative** or **unconservative**, usually influences the timing of earnings or losses rather than their aggregate amount. As a result, unjustified excesses in either direction may mislead one group of investors to the possible benefit or detriment of others.

97. The best way to avoid the injury to investors that **imprudent** reporting creates is to try to ensure that what is reported represents what it purports to represent. It has been pointed out in this Statement that the reliability of financial reporting may be enhanced by disclosing the nature and extent of the uncertainty surrounding events and transactions reported to stockholders and others. In assessing the prospect that as yet uncompleted transactions will be concluded successfully, a degree of skepticism is often warranted. The aim must be to put the users of financial information in the best possible position to form their own opinion of the probable outcome of the events reported. **Prudent** reporting based on a healthy skepticism builds confidence in the results and, in the long run, best serves all of the divergent interests that are represented by the Board's constituents.

n.b. Conservatism/Prudence not shown in this summary graph of SFAC 2!

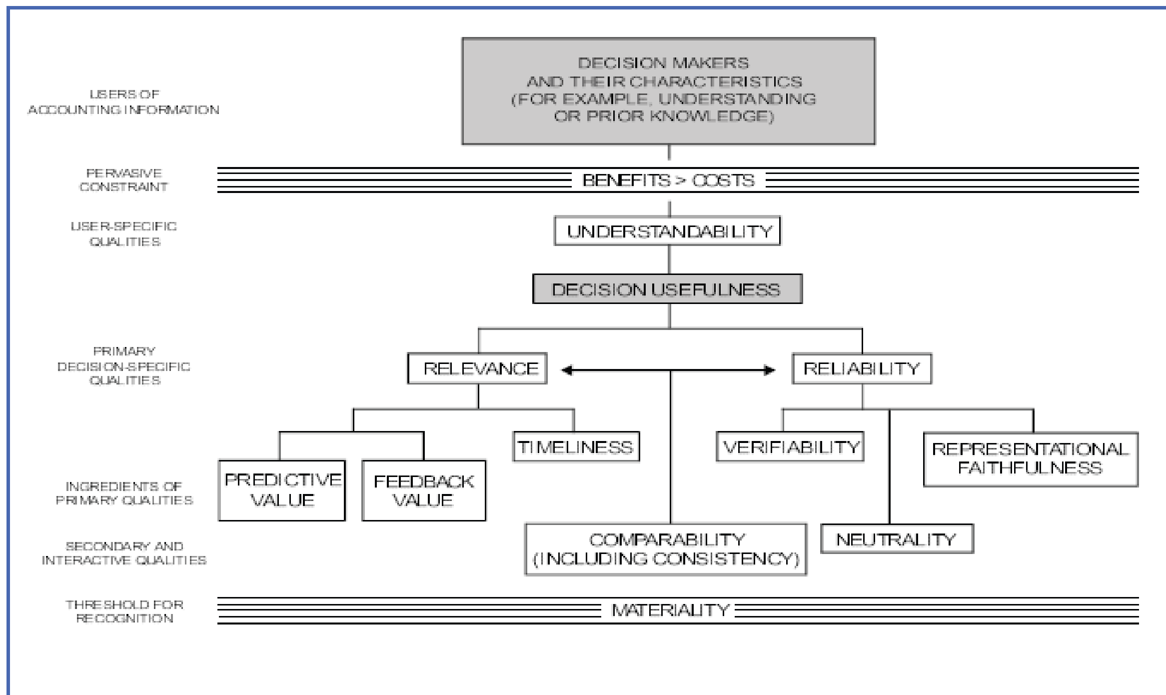

Figure 1: SFAC #2

The need for trade-offs between all of these desirable qualitative characteristics has always been recognized but no conceptual framework has been able/attempted to resolve this. Take the Canadian framework (quite similar in nature) and the following comment:

Generally, the aim is to achieve an appropriate balance among the characteristics in order to meet the objective of financial statements. The relative importance of the characteristics in different cases is a matter of professional judgment' (Par. 1000.24)

<u>SFAC#8 Concepts Statement No. 8 — Conceptual Framework for Financial Reporting — Chapter 1, The Objective of General Purpose Financial Reporting, and Chapter 3, Qualitative Characteristics of Useful Financial Information (a replacement of FASB Concepts Statements No. 1 and No. 2) September 2010</u>

(Joint project with IASB, see also IASB 2010 Conceptual Framework)

Prudence (**conservatism**) and neutrality

BC3.27 Chapter 3 does not include **prudence** or **conservatism** as an aspect of faithful representation because including either would be inconsistent with neutrality. Some respondents to the Discussion Paper and Exposure Draft disagreed with that view. They said that the framework should include **conservatism**, **prudence**, or both. They said that bias should

not always be assumed to be undesirable, especially in circumstances when bias, in their view, produces information that is more relevant to some users.

BC3.28 Deliberately reflecting **conservative** estimates of assets, liabilities, income, or equity sometimes has been considered desirable to counteract the effects of some management estimates that have been perceived as excessively optimistic. However, even with the prohibitions against deliberate misstatement that appear in the existing frameworks, an admonition to be **prudent** is likely to lead to a bias. Understating assets or overstating liabilities in one period frequently leads to overstating financial performance in later periods—a result that cannot be described as **prudent** or neutral.

BC3.29 Other respondents to the Exposure Draft said that neutrality is impossible to achieve. In their view, relevant information must have purpose, and information with a purpose is not neutral. In other words, because financial reporting is a tool to influence decision making, it cannot be neutral. Obviously, reported financial information is expected to influence the actions of users of that information, and the mere fact that many users take similar actions on the basis of reported information does not demonstrate a lack of neutrality. The Board does not attempt to encourage or predict specific actions of users. If financial information is biased in a way that encourages users to take or avoid predetermined actions, that information is not neutral.

(c) *IASB/IFRS*

International Accounting Standards Committee (IASC) International Accounting Standard No. 1, *Disclosure of Accounting Policies (Year 1975 replaced in 1997)*

Prudence, substance over form, and materiality should govern the selection and application of accounting policies - prudence was described as follows:

"Uncertainties inevitably surround many transactions. This should be recognized by exercising **prudence** in preparing financial statements. **Prudence** does not, however, justify the creation of secret or hidden reserves."

IASB Framework for the Preparation and Presentation of Financial Statements The IASB Framework was approved by the IASC Board in April 1989 for publication in July 1989, and adopted by the IASB in April 2001.

QUALITATIVE CHARACTERISTICS OF FINANCIAL STATEMENTS
Item 37 (as a component of Reliability)
The preparers of financial statements do, however, have to contend with the uncertainties that inevitably surround many events and circumstances, such as the collectability of doubtful receivables, the probable useful life of plant and equipment and the number of warranty claims that may occur. Such uncertainties are recognised by the disclosure of their nature and extent and by the exercise of **prudence** in the preparation of the financial statements. **Prudence** is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of **prudence**

does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because the financial statements would not be neutral and, therefore, not have the quality of reliability.

IAS 1 (1997) – transferred to IAS 8 (2003)

(Par. 10) In the absence of an IFRS that specifically applies to a transaction, other event or condition, management shall use its judgement in developing and applying an accounting policy that results in information that is:
(a) relevant to the economic decision-making needs of users; and
(b) reliable, in that the financial statements:

- (i) represent faithfully the financial position, financial performance and cash flows of the entity;
- (ii) reflect the economic substance of transactions, other events and conditions, and not merely the legal form;
- (iii) are neutral, i.e. free from bias;
- (iv) are prudent; and
- (v) are complete in all material respects.

2010 Conceptual Framework for Financial Reporting

(Joint project with FASB, see also SFAC#8)

Prudence (**conservatism**) and neutrality

BC3.27 Chapter 3 does not include **prudence** or **conservatism** as an aspect of faithful representation because including either would be inconsistent with neutrality. Some respondents to the Discussion Paper and Exposure Draft disagreed with that view. They said that the framework should include **conservatism**, **prudence**, or both. They said that bias should not always be assumed to be undesirable, especially in circumstances when bias, in their view, produces information that is more relevant to some users.

BC3.28 Deliberately reflecting **conservative** estimates of assets, liabilities, income, or equity sometimes has been considered desirable to counteract the effects of some management estimates that have been perceived as excessively optimistic. However, even with the prohibitions against deliberate misstatement that appear in the existing frameworks, an admonition to be **prudent** is likely to lead to a bias. Understating assets or overstating liabilities in one period frequently leads to overstating financial performance in later periods—a result that cannot be described as **prudent** or neutral.

BC3.29 Other respondents to the Exposure Draft said that neutrality is impossible to achieve. In their view, relevant information must have purpose, and information with a purpose is not neutral. In other words, because financial reporting is a tool to influence decision making, it cannot be neutral. Obviously, reported financial information is expected to influence the actions of users of that information, and the mere fact that many users take similar actions on the basis of reported information does not demonstrate a lack of neutrality. The Board does not attempt to encourage or predict specific actions of users. If financial information is biased in a

way that encourages users to take or avoid predetermined actions, that information is not neutral.

DP 2013/1 July 2013, A Review of the Conceptual Framework for Financial Reporting

On p. 13 we find the following: 'Section 9 discusses: (a) the IASB's approach to Chapter 1 *The Objective of General Purpose Financial Reporting* and Chapter 3 *The Qualitative Characteristics of Useful Financial Information* of the existing *Conceptual Framework*. The IASB does not intend to fundamentally reconsider the content of these chapters. However, the IASB will make changes to those chapters if work on the rest of the *Conceptual Framework* highlights areas within those chapters that need clarifying or amending. Section 9 also discusses the concerns that some have raised with how these chapters deal with the issues of stewardship, reliability and **prudence**.'

In section 9 (p. 184-185) we find the following discussion:

Prudence

9.15 Both paragraph QC12 of Chapter 3 and paragraph 36 of the pre-2010 Conceptual Framework state that financial statements should be neutral, that is, free from bias. However, the pre-2010 Conceptual Framework went on to describe the concept of **prudence**. Chapter 3 does not include any reference to **prudence**.

9.16 Paragraph 37 of the pre-2010 Conceptual Framework describes **prudence** as follows: **Prudence** is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of **prudence** does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because the financial statements would not be neutral and therefore, not have the quality of reliability.

9.17 Hence, the pre-2010 Conceptual Framework expressed the view that the exercise of **prudence** need not be inconsistent with neutrality.

9.18 In developing Chapter 3 of the Conceptual Framework, the IASB removed reference to the concept of **prudence**. The Basis for Conclusions on Chapter 3 explains that **prudence** was not included as an aspect of faithful representation because:
(a) including a reference to **prudence** would be inconsistent with neutrality. Even with the prohibitions against deliberate misstatement that appear in the pre-2010 Conceptual Framework, a requirement to be **prudent** would lead to bias in the preparation of financial statements.
(b) deliberately understating assets or overstating liabilities in one period often leads to overstating financial performance in later periods.

9.19 Many continue to object to the removal of the reference to **prudence** from the Conceptual Framework, stating that:
(a) deliberately reflecting **conservative** estimates in the financial statements may be desirable to counteract the effect of over-optimistic management estimates.

(b) such a removal could result in the recognition of assets and gains whose existence is uncertain and the non-recognition of some possible liabilities and possible losses. The IASB's proposed approach to situations where the existence of an asset or a liability is uncertain is discussed in Section 2.
(c) such a removal may increase the use of current value measurements (including fair value), which some view as inherently unverifiable and prone to error.

9.20 Few would disagree with the idea expressed in the pre-2010 Conceptual Framework that a preparer should exercise **caution** when making estimates and judgements under conditions of uncertainty. This idea is reflected in many of the decisions that the IASB makes when setting Standards.

9.21 However, it is unclear whether some who call for the reintroduction of references to **prudence** would agree with the description of **prudence** as the exercise of caution when making estimates and judgements under conditions of uncertainty. Some would prefer financial statements to show a bias towards **conservatism** and reject the notion of neutrality.

9.22 As noted in paragraph 9.19, some have expressed a fear that removing **prudence** will lead to a much more widespread use of current value measurements than at present. Section 6 on measurement indicates the factors that the IASB believes it will need to consider when determining which measurement to adopt when developing or revising particular Standards. It is not clear that including **prudence** as an additional factor to consider would result in a significantly different outcome.

<u>ED/2015/3 May 2015, Conceptual Framework for Financial Reporting</u>

ED proposes:

- clearly stating that assessing management's stewardship of the entity's resources is also an objective of financial reporting
- explains the roles of prudence and substance over form in financial reporting, i.e, reintroduce an explicit reference to the notion of **prudence** (described as **caution** when making judgements under conditions of uncertainty) and state that **prudence** is important for achieving neutrality (see paragraphs 2.18 and BC2.1–BC2.17)

2.18 Neutrality is supported by the exercise of prudence. **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 mis-statements can lead to the overstatement of income or the understatement of expenses in future periods.

Basis for conclusion (BC2.1 – BC2.17):

Arguments to not include **prudence**

(a) there is no common understanding of what **prudence** means. Different parties interpret it differently. Consequently, including the word in the *Conceptual*

Framework could lead to inconsistent application. Moreover, prudence could be misinterpreted in a way that is inconsistent with neutrality.
(b) the exercise of **prudence**, as interpreted by some, leads to greater subjectivity in the financial statements, which can make it difficult to assess an entity's financial performance.

Arguments to reinstate **prudence**:

(a) some Standards, both existing and proposed, use accounting treatments that some view as motivated by a desire for **prudence**. It is therefore important to explain prudence in the *Conceptual Framework* so that it can be applied consistently.
(b) **prudence** is needed to counteract management's natural bias towards optimism.
(c) investors are more concerned about downside risk than upside potential. **Prudence** helps to address this concern.
(d) academic research has suggested that some forms of conservatism (a concept often regarded as similar to **prudence**) have a role to play in financial reporting in some cases. However, there are different views about what forms of conservatism are helpful, when and why.
(e) the exercise of **prudence** helps to align the interests of shareholders and managers and can reduce moral hazard.
(f) the financial crisis has demonstrated the need for **prudence** when making estimates.

Cautious **prudence** vs asymmetric **prudence**:

No need for asymmetric **prudence** as a principal.

Policies that treat gains and losses asymmetrically can result in more relevant that faithfully represents what it purports to represent. They can also be neutral: not intended to increase the probability that financial information will be received favourably or unfavourably by users.

(d) *EU directives*

Council Directive 78/660/EEC (4th directive)

Article 31 (c)
Valuation must be made on a **prudent** basis, and in particular:

a) only profits made at the balance sheet date may be included,
b) account must be taken of all foreseeable liabilities and potential losses arising in the course of the financial year concerned or of a previous one, even if such liabilities or losses become apparent only between the date of the balance sheet and the date on which it is drawn up,
c) account must be taken of all depreciation, whether the results of the financial year is a loss or a profit.

DIRECTIVE 2013/34/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC (4th directive) and 83/349/EEC (7th directive)

Preambles (4)
Annual financial statements pursue various objectives and do not merely provide information for investors in capital markets but also give an account of past transactions and enhance corporate governance. Union accounting legislation needs to strike an appropriate balance between the interests of the addressees of financial statements and the interest of undertakings in not being unduly burdened with reporting requirements.

Preambles (9)
Annual financial statements should be prepared on a **prudent** basis and should give a true and fair view of an undertaking's assets and liabilities, financial position and profit or loss. It is possible that, in exceptional cases, a financial statement does not give such a true and fair view where provisions of this Directive are applied. In such cases, the undertaking should depart from such provisions in order to give a true and fair view. The Member States should be allowed to define such exceptional cases and to lay down the relevant special rules which are to apply in those cases. Those exceptional cases should be understood to be only very unusual transactions and unusual situations and should, for instance, not be related to entire specific sectors.

Preambles (16)
To ensure the disclosure of comparable and equivalent information, recognition and measurement principles should include the going concern, the **prudence**, and the accrual bases.

Preambles (22)
The recognition and measurement of some items in financial statements are based on estimates, judgements and models rather than exact depictions. As a result of the uncertainties inherent in business activities, certain items in financial statements cannot be measured precisely but can only be estimated. Estimation involves judgements based on the latest available reliable information. The use of estimates is an essential part of the preparation of financial statements. This is especially true in the case of provisions, which by their nature are more uncertain than most other items in the balance sheet. The evidence considered should include any additional evidence provided by events after the balance-sheet date.

Article 6

General financial reporting principles

1. Items presented in the annual and consolidated financial statements shall be recognised and measured in accordance with the following general principles:

...

(c) recognition and measurement shall be on a **prudent** basis, and in particular:

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

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

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

(e) *Plan Comptable Général*

Titre I. Object et principes de la comptabilité
Chapitre II. Principes
120-3. Prudence
La comptabilité est établie sur la base d'appréciations prudentes, pour éviter le risque de transfert, sur des périodes à venir, d'incertitudes présentes susceptibles de grever le patrimoine et le résultat de l'entité.

(f) *Conclusion*

While APB Statement was actually critical of conservatism, since then, prudence or conservatism, when it has been included at all as a characteristic in the frameworks has been uniformly defined as a cautionary reaction to uncertainty and this is again what is planned with the new proposed framework. None of the frameworks have embraced a deliberate understatement of assets and revenues, or a deliberate overstatement of liabilities and expenses. The EU Directives as benn more difficult to interpret. In the next section, we will ask ourselves whether IFRSs are conservative and should they be conservative.

5. PRUDENCE IN THE ACADEMIC LITERATURE

(a) *Distinguishing between "good" conservatism and "bad" conservatism*

The literature makes a critical distinction between **unconditional conservatism** and **conditional conservatism** (Beaver & Ryan, 2005; Pope & Walker, 2003). On the one hand, **unconditional conservatism** – also known as *ex ante* or news-independent conservatism or also balance sheet conservatism – consists in systematically understating the book value of net assets relatively to their economic value. This accounting bias toward reporting lower earnings early in the life of a project and lower book values of assets leads to higher (internally generated) un-booked goodwill and higher market-to-book ratio. Unconditional conservatism is a primary source of unrecorded goodwill, which also captures the present value of expected economic profits (e.g., rents, growth). **Unconditional conservatism** mechanisms include: routinely over-expensing, routinely expensing early or routinely deferring revenue recognition, independent of true economic income. Examples of unconditional conservatism include: expensing most costs related to internally developed intangibles; accelerated depreciation methods for property, plant, and equipment (usually driven by tax payments minimization incentives); historical cost accounting for positive net present value projects; systematic amortization of (purchased) goodwill. For instance, in Germany, creditor protection has been considered as the main factor explaining why pre-IFRS German firms "have engaged in unconditionally conservative practices such as charging future operating expenses against current period

income" (Ball, Robin, & Sadka, 2008, p. 194). In France, rules to compute taxable income generated a strong incentive for accelerated depreciation methods. The various fair value options, the capitalization of development costs, or the change from goodwill amortization under domestic GAAP to impairment testing under IFRS are a few examples of an attempt to reduce unconditional conservatism.

On the other hand, **conditional conservatism** (also known as *ex post* or news-dependent conservatism or earnings conservatism) consists in writing down book values and decreasing income under sufficiently adverse circumstances. Conversely, book value is not written up when circumstances are favorable. Basu (1997) explains **conditional conservatism** as 'Accountants' tendency to require a higher degree of verification for recognizing good news than bad news in financial statements. Examples of **conditional conservatism** include asset impairments (for tangible and intangible fixed assets, financial instruments), accounting for inventories at lower of cost or market, and provisions.

Pope and Walker (2003) and Beaver and Ryan (2005) explain how the two forms of conservatisms are negatively related: lower *ex ante* unconditional conservatism is a condition for higher *ex post* conditional conservatism (see García Lara & Mora, 2004). Indeed, lower book values lower the threshold triggering conditional conservatism mechanisms, and *vice versa*. Unconditional conservatism "constitutes a form of 'accounting slack' that pre-empts the application of conditional conservatism unless news is sufficiently bad to use up that slack" (Beaver & Ryan, 2005, p. 270). Pope and Walker (2003, p. 2) also shed light on this relation: "*Ceteris paribus*, when the proportion of market value accounted for by recognized assets is relatively high, a decrease in market value (bad news) is more likely to be attributable to assets currently recognized on the balance sheet." To exemplify this negative relation, taking the extreme case where an investment is completely expensed (e.g., most internally generated intangible assets) there is no possibility to book any impairment, even under extremely adverse circumstances, because there is no asset to impair.

There is general acceptance among standard setters that unconditional conservatism, as a deliberate understatement of asset values and earnings, is a form of 'bad' prudence (EFRAG, ANC, ASCG, OIC, & FRC, 2013 § 11), while conditional conservatism has been recognized as a qualitative characteristic of financial reporting for decades at national or supra national levels by standard setters in Europe (EFRAG et al., 2013 § 1-2).

(b) *Metrics used to measure conditional and unconditional conservatism*

The asymmetric treatment of gains and losses is generally captured in the literature by the pricewise-linear regression of accounting earnings and stock returns, i.e. the Basu (1997) model:

$$NI_t/MV_{t-1} = \beta_0 + \beta_1 BN_t + \beta_2 R_t + \beta_3 BN_t R_t + E_t$$

where
R_t market return defined as $(MV_t - MV_{t-1} + D_t)/MV_{t-1}$
D_t dividends net of capital contributions during the year t
MV_t market value of the firms at the end of the year t
BN_t dummy variable equal to 1 if R_t is negative, and 0 otherwise

Coefficient β_2 on the market return measures the timeliness of gain recognition or the responsiveness of earnings to good news, while the sum $\beta_2 + \beta_3$ measures the timeliness of loss recognition or the responsiveness of earnings to bad news. As explained in Pope and Walker (1999), the β_3 coefficient, i.e; the product of market return and the negative return dummy measures incremental timeliness of loss recognition. A positive and significant coefficient implies asymmetric timely loss recognition and therefore conditional conservative accounting.

The Basu (1997) model captures conservatism at the sample level. More recent literature, adopt the Khan and Watts (2009) extension of the model which is a firm specific metric. Khan and Watts (2009) argue that conditional conservatism is influenced by three variables – size, market-to-book ratio and leverage – that capture the four factors that drive conservatism identified in Watts (2003) (contracting, litigation, taxation, and regulation). Hence the model becomes:

$$NI_t/MV_{t-1} = \beta_0 + \beta_1 BN_t + \beta_2 R_t + \beta_3 BN_t R_t$$
$$+ \beta_4 SIZE_t + \beta_5 SIZE_t BN_t + \beta_6 SIZE_t R_t + \beta_7 SIZE_t BN_t R_t$$
$$+ \beta_8 MB_t + \beta_9 MB_t BN_t + \beta_{10} MB_t R_t + \beta_{11} MB_t BN_t R_t$$
$$+ \beta_{12} LEV_t + \beta_{13} LEV_t BN_t + \beta_{14} LEV_t R_t + \beta_{15} LEV_t BN_t R_t + E_t$$

where R_t market return defined as $(MV_t - MV_{t-1} + D_t)/MV_{t-1}$
D_t dividends net of capital contributions during the year t
MV_t market value of the firms at the end of the year t
BN_t dummy variable equal to 1 if R_t is negative, and 0 otherwise
$SIZE_t$ log of the market value at the end of the year t
MB_t market to book ratio of equity at the end of the year t
LEV_t debt scaled by market value (leverage) at the end of the year t

Next, C_Score, measuring earnings incremental responses to bad news, can be computed at firm and year level as:

$$C_Score_t = \beta_3 + \beta_7 SIZE_t + \beta_{11} MB_t + \beta_{15} LEV_t$$

On the other hand, unconditional conservatism is captured by the residual of annual cross-sectional regressions of the market-to-book ratio of equity to several variables that previous research (Rochowdhury and Watts, 2007; Piot et al. 2011) has shown to be correlated to the dependant variable (i.e., market returns, level of intangibles, net value of property plant and equipment, capital expenditures, change in sales, return on equity, volatility, leverage, and size). Hence, the regression used for each year to determine the level of unconditional conservatism is:

$$MB_{it} = \beta_1 + \beta_2 R_{it} + \beta_3 INTAN_{it} + \beta_4 PPEN_{it} + \beta_5 CAPEX_{it} + \beta_6 \Delta SALES_{it} + \beta_7 ROE_{it}$$
$$+ \beta_8 VOLAT_{it} + \beta_9 LEV_{it} + \beta_{10} SIZE_{it} + \varsigma$$

where:

$INTAN_{it}$ = intangible assets (including goodwill) of firm i at the end of the year t, scaled by total assets;
$PPEN_{it}$ = net value of property plant and equipment of firm i at the end of the year t, scaled by total assets;
$CAPEX_{it}$ = capital expenditures firm i at the end of the year t, scaled by total assets;
$\Delta SALES_{it}$ = percentage change in sales of firm i in year t;
ROE_{it} = net income firm i in year t, scaled by equity;
$VOLAT_{it}$ = price volatility of the share of the firm i in year t;

All other variables are defined above.

Market-to-book ratio of equity is influenced by two factors: (1) the unverifiable (un-booked) increases in value of separable assets in place (true unconditional conservatism), and (2) the expected value of economic profits (e.g., synergies between assets in place, growth, rents) (Roychowdhury & Watts, 2007). By adjusting the market-to-book ratio for expected growth, the residuals from the equation above represent a proxy for unconditional conservatism.

(c) *Are IFRSs conservative?*

Up to recently, the IASB's and FASB's conceptual frameworks had a place for conservatism or 'prudence', a dimension of reliability that is one of the four principal qualitative characteristics of financial statements. To the surprise of many, the new chapter on qualitative characteristics (Chapter 2) of both the IASB and FASB, adopted in 2010 but discussed since the early 2000s does not include conservatism or 'prudence' as a desirable quality of financial reporting (IASB, 2010). The IASB considers 'faithful representation' as a fundamental qualitative characteristic of financial information which implies a focus on completeness, neutrality, and freedom from errors. Examples of 'neutrality' under IFRS include greater use of fair values, impairment testing rather than amortization, including the possibility to reverse prior impairments for assets with finite useful life, and stricter rules on how and when to book provisions.[1] However, as already explained above, the form of 'prudence' that the IASB intended to eliminate from financial reporting is actually related to unconditional conservatism, not conditional conservatism (see IASB, 2008, p. § BC2.21). From a conceptual perspective, the IASB framework and IFRS promote conditional conservatism while limiting unconditional conservatism with respect at least to levels that were found in previous National GAAP. Hellman (2008) also suggest a move from 'consistent' conservatism to temporary 'conservatism'.

It is often argued by observers (like the press) that IFRS are 'less prudent' than national GAAP for two main reasons. First, the term 'prudence' has been removed from the conceptual framework (IASB, 2010). Second, IFRS allow various fair value options that would be imprudent *per se*. Regarding the first argument and according to the IASB, prudence conflicts with the quality of neutrality and the Board explained in 2008 that "[t]he exercise of prudence does not allow for deliberate understatement of assets or income or overstatement of liabilities or expenses. [...] Introducing bias in understatement of assets (or overstatement of liabilities) in one period frequently leads to overstating financial performance in later periods – a result that cannot be described as prudent" (IASB, 2008, p. § BC2.21). The form of 'prudence' that the Board intended to eliminate from the conceptual framework (and financial reporting) can be clearly related to unconditional conservatism, not to conditional conservatism. It is also clear that the Board describes the negative relation between unconditional conservatism and conditional conservatism which is also discussed in the literature (e.g., Beaver & Ryan, 2005; Pope & Walker, 2003).[2] Regarding the second argument, fair value for financial assets does not significantly affect many industries other than the financial sector, and if firms decide to follow the fair value option, both unrealized gains (good news) and unrealized losses (bad news) are recognized in earnings (or other comprehensive income). Fair value cannot be considered less conditionally conservative than amortized cost.[3]

[1] IAS 37 is said by many to curtail 'cookie jar reserves or provisions' quite prevalent in Continental Europe, (see Walton, 2011) for a discussion.
[2] The new chairman of the IASB, Hans Hoogervorst, reiterated the argument according to which IFRS include various mechanisms ensuring prudence of financial reporting (Hoogervorst, 2012). See Appendix C.
[3] Under IAS 16, optional revaluations of property, plant and equipment are recorded as a gain in other comprehensive income (OCI). Subsequent negative fair value adjustments are first recorded as a loss in OCI (as a reversal of the previously booked gains), and then as a loss in earnings. Under IAS 40, both gains and losses of investment properties are included in earnings under the fair value option. Under IAS 39, both gains and losses on

For a further discussion see Cairns (2006) and Nobes (2015). A detailed analysis of Nobes (2015) is presented in Appendix B. He concludes:

> 'In conclusion, most of the new standards (11 of the 15) written by the IASB contain no requirement or permission to use 'the FV basis'. The remaining four standards do contain the FV basis, but one of them merely clarifies that the permission to use it that already existed in old standards covers particular assets (IFRS 6), one applies to assets of unusual entities (IFRS 10), one applies to unusual liabilities (IFRS 2), and one replaces an old standard which entails similar amounts of FV (IFRS 9). In addition, some IFRSs use FV in the context of one-off initial measurement, and one for writing down an asset. In some of these cases, the content of the IFRS is close to that in an IAS which it replaced.'

Conversely, IFRS do include various mechanisms ensuring the application of conditional conservatism, such as the recognition of probable liabilities vs. the non-recognition of contingent assets (IAS 37), the lower of cost or net realizable values for inventories (IAS 2), or impairment for financial assets and long-lived assets (IAS 39 and IAS 36), to name a few, see Barker and McGeachin (2015). A detailed analysis by these authors as to the level of conservatism in IFRSs is presented in Appendix A. Their analysis would suggest that there are a number of instances of unconditional recognition conservatism (IAS 11, IAS 17, IAS 18, IAS 19, IAS 20, IAS 23, IAS 37, IAS 38, IFRS 2, IFRS 15), of conditional measurement conservatism (IAS 2, IAS 11, IAS 16, IAS 17, IAS 36, IAS 38, IAS 39, IAS 40, IFRS 4, IFRS 5, IFRS 6. IFRS 9, IFRS 15) and some disclosure conservatism (IAS 16, IAS 33, IFRS 7, IFRS 12).

For instance, directly translating the idea of conditional conservatism, IAS 36 § 1 states "The objective of this standard is to prescribe the procedures that an entity applies to ensure that its assets are carried at no more than their recoverable amount. [...] If this is the case, the asset is described as impaired and the standard requires the entity to recognise an impairment loss [in earnings]." IFRS introduced relatively more stringent and systematic impairment-testing rules relying on fair value estimates than local GAAP. This is particularly the case for intangible assets with an indefinite useful life among which goodwill. Goodwill is tested for impairment systematically once a year but was amortized under domestic GAAP prior to the adoption of IFRS over periods ranging from 5 to 20 years (see Nobes & Parker, 2010).[4]

Therefore, from a conceptual perspective, IFRS can be considered conditionally conservative. *Ceteris paribus*, the adoption of IFRS should lead to an increase in the degree of conditional conservatism. However, there is evidence that the considerable discretion permitted by IFRS may have prevented financial reporting from reaching the level of conditional conservatism targeted by the IASB. Christensen, Lee, and Walker (2015), examining voluntary adopters vs. mandatory adopters in Germany, show that "the flexibility embedded in IFRS might render it ineffective in restricting earnings management of firms with low incentives to comply." Similarly, there are particular concerns about a potential inappropriate application and enforcement of impairment tests which can arguably be considered as IFRS' main mechanism ensuring conditional conservatism (e.g., Kim, Lee, & Yoon, 2013; Lawrence, Sloan, & Sun, 2013; Roychowdhury & Martin, 2013). Lawrence et al. (2013) explain that conservatism results (partly) from the requirement that "non-financial assets must be written down when their fair

financial instruments designated at fair value affect earnings while only significant loss (impairment) affect earnings for financial instruments measured at cost.

[4] For instance, under local GAAP goodwill was usually amortized over 20 years in the UK, 15 years in Germany, less than 20 years in France, 5 years in Italy, and between 5 and 10 years in Spain.

value drop sufficiently below their carrying value, but generally cannot be written up when their fair value rise above their carrying values" (p. 112).

Impairment tests play a critical role in the degree of conditional conservatism for three raisons. First, IFRS introduced more stringent impairment-testing rules in particular for intangible assets with indefinite useful life such as goodwill. Second, impairment tests need to be applied to a large proportion of balance sheet items (all tangible and intangible fixed assets, including goodwill).[5] Third, they are relevant to firms in the non-financial sectors. However, the implementation of impairment tests (in particular for intangibles with indefinite useful life) usually relies on valuation models, requires 'significant judgment' from managers (Hilton & O'Brien, 2009; Petersen & Plenborg, 2010, p. 420), and is prone to manipulation by managers because it relies on unverifiable fair value estimates (Bens, Heltzer, & Segal, 2011; Hayn & Hughes, 2006; K. K. Li & Sloan, 2011; Ramanna, 2008; Ramanna & Watts, 2012). Hans Hoogervorst, Chairman of the IASB, acknowledges his "concerns about goodwill resulting from business combinations" and admits that "[g]iven its subjectivity, the treatment of goodwill is vulnerable to manipulation of the balance sheet and the P&L" (Hoogervorst, 2012, p. 5). The European Securities and Market Authority (ESMA) recently expressed concerns about insufficient impairment recognition by major listed European companies during the financial crisis (see ESMA, 2013). Various professional reports by large auditors or other consulting firms have also documented this lack of recognition of economic impairment for several years.[6] Further studies have documented an incomplete and heterogeneous level of compliance with disclosure requirements under IFRS 3 and IAS 36 (Amiraslani, Latridis, & Pope, 2013; Glaum, Schmidt, Street, & Vogel, 2013; Mazzi, André, Dyonisia, & Tsavaloutas, 2014; Paugam & Ramond, 2014; Tsavaloutas, André, & Dyonisia, 2014). Finally, the press recently echoed insufficient and untimely recognition of economic impairment for goodwill.[7] The effect of the adoption of IFRS in 2005 on conditional conservatism in Europe remains therefore an empirical question and it is most likely dependent on the capacity to enforce various conditional conservatism mechanisms, among which impairment-testing principles for non-financial assets play a critical role.

While there have been numerous country-specific and cross-country studies on the effects of mandatory IFRS adoption on various dimensions of accounting quality such as value relevance (e.g., Barth, Landsman, & Lang, 2008; Capkun, Cazavan-Jeny, Jeanjean, & Weiss, 2008; Filip, 2010; Tsalavoutas, André, & Evans, 2012) or earnings management (Barth et al., 2008) and other economic consequences, for example on the cost of capital (e.g., Daske, Hail, Leuz, & Verdi, 2008; S. Li, 2010), there are only a couple of papers analysing the effects of IFRS on accounting conservatism.[8]

Ahmed, Neel, and Wang (2013) examine the effect of the adoption of IFRS using data spanning 2002 to 2007 from 20 countries around the world on various measures of accounting quality,

[5] According to IAS 36 § 2: Impairment testing procedures cover all assets but the following: inventories (IAS 2), construction contracts' assets (IAS 11), deferred tax assets (IAS 12), post-employment benefit assets (IAS 19), financial instruments (IAS 39), investment property measured at fair value (IAS 40), biological assets measured at fair value (IAS 41), specific assets that arise from insurance contracts (IFRS 4), and non-current assets held for sale and discontinued operations (IFRS 5).
[6] See Ernst & Young (2010) 'Meeting today's financial challenges – Impairment reporting: Improving stakeholder confidence' and Houlihan Lokey (2013) 'The European Goodwill Impairment Study 2012-2013'
[7] See Tata Steel – Goodwill Hunting, May 14th, 2013 on the website of The Economist. Available at: http://www.economist.com/news/business/21578082-what-corus-write-reveals-goodwill-hunting
[8] A detailed discussion of empirical research on the impact of IFRSs can be found in ICAEW (2015) which analysed some 200 papers. Singleton-Green (2015) discusses some of the issues with empirical research for subsequent use by regulators.

namely income smoothing, reporting aggressiveness, and the likelihood to meet or beat earnings benchmark. Ahmed et al. (2013), considering the methodological issues related to the Basu (1997) measure, use the asymmetric timeliness measure "only to supplement [their] accruals testing providing evidence on changes in aggressiveness of financial reporting after IFRS adoption and to compare [their] findings with prior work that has used timeliness of loss recognition measures" (p. 16).[9] The authors find a reduction in the timeliness of loss recognition after the adoption of IFRS in countries with strong enforcement. Ahmed et al. (2013) highlight that the increase discretion and flexibility permitted by IFRS could prevent financial reporting quality to increase despite strong enforcement.

In André, Filip, and Paugam (2015) we relate a potential change of the degree of conditional conservatism to institutional factors and/or inappropriate enforcement of a particular accounting mechanism that drives conditional conservatism, i.e. impairment tests. We examine pre and post levels of conditional conservatism for a sample of European firms that adopted IFRS in 2005 and find that the degree of conditional conservatism has decreased. This result holds across several measures of conditional conservatism and different time periods and it is less pronounced in countries with high auditing quality and strong enforcement.

We next investigate which channels led to a decrease of conservatism in financial reporting, i.e. the standards per se or the greater flexibility permitted by the standards and their inappropriate application. We show that the decrease in conditional conservatism after the adoption of IFRS is predictably related to asset impairment recognition and avoidance. Our first set of tests indicates that firms that recognize asset impairments exhibit a smaller decrease in the level of conditional conservatism relatively to non-impairers carrying the same asset type. Our second set of tests shows that firms that do not recognize asset impairment, although evidence suggests that they carry impaired assets, present a greater decline in the degree of conditional conservatism than other firms. These results hold for the impairment of any assets, of total intangible assets and of goodwill. For the sub-sample of firms carrying goodwill, results even show that the introduction of IFRS lead to an increase in conditional conservatism after controlling for the negative effect of non-impairers carrying economically impaired goodwill.

These results inform the stakeholders about a potential negative effect of the greater flexibility permitted by IFRS and/or lack of appropriate enforcement on a key dimension of accounting quality. The effect of the adoption of IFRS in 2005 on conditional conservatism in Europe is likely dependent on the capacity to apply and enforce various conditional conservatism mechanisms, among which impairment testing principles for non-financial assets play a critical role. Inappropriate enforcement of impairment tests is therefore a potential explanation. Untimely impairment allows managers to defer the recognition on bad news in earnings and reduce the level of conditional conservatism.

[9] Patatoukas and Thomas (2011) argue that the Basu (1997) measure suffers from scale effects, whereas Ball, Kothari, and Nikolaev (2013) demonstrate that the measure is affected by a correlated omitted variable issue that can be corrected with 'standard' estimation procedures such as the Khan and Watts (2009) version of the Basu (1997) measure.

(d) *Some consequences of less conservatism*

On financial statements and financial statement users

Ruch and Taylor (2014) present an in depth review of academic studies examining the effects of conservatism on financial statements and financial statement users. They focus on three users 1) equity market users, 2) debt market users and 3) corporate governance users. We reproduce survey tables in Appendix D. Most of these are American studies. Further, like much research in accounting, there is serious issues of endogeneity, i.e., what causes what (do more conservative firms recruit more conservative boards or more conservative boards lead to more conservative accounting)?

They conclude overall that (p. 30): 'Research has found that conditional conservatism alleviates information asymmetry for equity market users, but reduces analyst forecast accuracy. Additionally, conditional conservatism reduces the debt cost of capital for borrowers, makes executive compensation more sensitive to accounting earnings, and incentivizes managers to make fewer negative NPV investments. Finally, research on conservatism's effect on value relevance of earnings and equity cost of capital is inconclusive.'

Investment efficiency

In André, Filip, and Marmousez (2014) we go one step further and try to identify a potential real economic consequence of the previously reported decrease in conditional conservatism post-IFRS. The theory establishes that conditional conservatism is likely to improve investment efficiency, since more conservative accounting information presumably reduces the information asymmetry between the firm and its capital providers, and should therefore make corporate investment policies more optimal. While a theoretical link between conservatism and investment efficiency has been established by previous research, e.g. Garcia Lara et al (2016), the question is whether this link still remains after the adoption of IFRS, given that the mandatory IFRS adoption decreased the level of conditional conservatism. The French environment is a particularly suitable setting to study the above mentioned research question as the prudence principle was fundamental under French GAAP.

Reducing information asymmetry is considered one of the positive consequences of the introduction of IFRS, which supposedly improve the transparency and comparability of accounting information. The mandatory IFRS adoption should therefore have an ultimately positive effect on investment efficiency. However, this link is not easily established, because IFRS' decreased the level of conditional conservatism, an important financial reporting quality. In other words, the introduction of IFRS potentially has a dual effect on investment efficiency: a direct positive effect by reducing information asymmetry, and an indirect negative effect, by reducing conditional conservatism.

We investigate whether the introduction of IFRS has neutralized conservatism's positive influence on investment efficiency. Using a sample of French firms, we test the hypothesis that the move to IFRS has an unfavourable impact on the association between conditional conservatism and investment efficiency. The results show that in the pre-IFRS period, conditional conservatism is negatively associated with the absolute value of abnormal investments, whereas in the post-IFRS period conditional conservatism no longer plays a role. The results also show that conditional conservatism is negatively linked to the likelihood of

over- or under- investment in the pre-IFRS period, but that cease to be the case in the post-IFRS period.

Another interesting result is that the quality of accruals, another dimension of financial reporting quality, plays an important role over the whole study period in disciplining investment, and its role grows with the adoption of IFRS. If the quality of accruals is analyzed in connection with the concept of neutrality, i.e. as a way to reduce bias and subjectivities in accounting choices and estimates, then from this standpoint, the adoption of IFRS seems to be beneficial for investment efficiency. In the current debates, the international standard setter generally emphasizes its objective of neutrality. But by encouraging more neutral information, which theoretically has better predictive value especially as regards cash flows, the IASB limits conservatism. Our empirical observations suggest that if conservatism is losing its regulation power over investment efficiency, the quality of accruals, which reflects the principle of neutrality, is taking over.

Cost of contracting

Ball, Li & Shivakumar (2015) argue that a number of properties of IFRS potentially affect the contractibility or transparency of financial information. They suggest IFRS give to many choices to managers and increased an emphasis on fair values. While we would agree with the former to a certain degree, see the work of (Kvaal & Nobes, 2012), we have some issues with the latter at least for commercial and industrial companies, see Cairns (2006) and Nobes (2015). Nevertheless, they find a significant reduction in the use of accounting covenants following mandatory adoption of IFRS (noting a higher proportion for banks). If this lead to the use of tailored accounting principles (TAP), it could imply lower contracting efficiency or higher cost of contracting.

6. SHOULD IFRS BE CONSERVATIVE?

In the current ED/2015/3 May 2015, Conceptual Framework for Financial Reporting, the Basis for conclusion (BC2.1 – BC2.17) section clearly spells out the usual arguments for and against prudence:

Arguments to not include **prudence**

(a) there is no common understanding of what **prudence** means. Different parties interpret it differently. Consequently, including the word in the *Conceptual Framework* could lead to inconsistent application. Moreover, prudence could be misinterpreted in a way that is inconsistent with neutrality.
(b) the exercise of **prudence**, as interpreted by some, leads to greater subjectivity in the financial statements, which can make it difficult to assess an entity's financial performance.

Arguments to reinstate **prudence**:

(a) some Standards, both existing and proposed, use accounting treatments that some view as motivated by a desire for **prudence**. It is therefore important to explain prudence in the *Conceptual Framework* so that it can be applied consistently.
(b) **prudence** is needed to counteract management's natural bias towards optimism.
(c) investors are more concerned about downside risk than upside potential. **Prudence** helps to address this concern.

(d) academic research has suggested that some forms of conservatism (a concept often regarded as similar to **prudence**) have a role to play in financial reporting in some cases. However, there are different views about what forms of conservatism are helpful, when and why.
(e) the exercise of **prudence** helps to align the interests of shareholders and managers and can reduce moral hazard.
(f) the financial crisis has demonstrated the need for **prudence** when making estimates.

The Accounting Advisory Forum (XV/7002/95 EN, 1995) pointed out a while back that a likely reason why **prudence** is interpreted so differently is the different understanding of the objectives of financial statements. It is a fact that historically in Europe the relative importance of the objectives of financial reporting and the role of financial statements have varied from country to country. In some Member States financial information was/is mainly used as a means of assuring shareholders and other interested parties (e.g. creditors) of the capability of the enterprise to produce distributable profits, to satisfy its obligations and to continue to exist as a going concern, while in other Member States it is mainly used as the basis for taking economic decisions by investors, particularly in the capital markets. The presentation of more **conservative** information, while in the former case is not perceived as constituting a major problem, is usually considered as misleading for the achievement of the latter objective. Accounts should be neutral and therefore be designed to represent the results of events that have actually happened rather than to achieve a predetermined, ulterior effect. A different use of financial information may however result in a different emphasis given to the accounting principles used in the preparation of the financial statements, and lead to different interpretations and applications of the same accounting principles and rules.

It has long been understood that accounting has the challenging task of trying to deal with two sometimes opposing objectives which are attempting to deal with two types of asymmetric information between managers and suppliers of funds: 1) the adverse selection problem and 2) the moral hazard problem. Adverse selection occurs because managers know more about the current position of the firm and its future prospects than do outside investors. Moral hazard occurs because it is impossible for investors to directly observe the extent and quality of manager's effort on their behalf. The problem will always be how to design and implement accounting principles that best trade-off the investor-informing and manager performance-evaluation roles of accounting information (Scott, 2009, see figure 2).

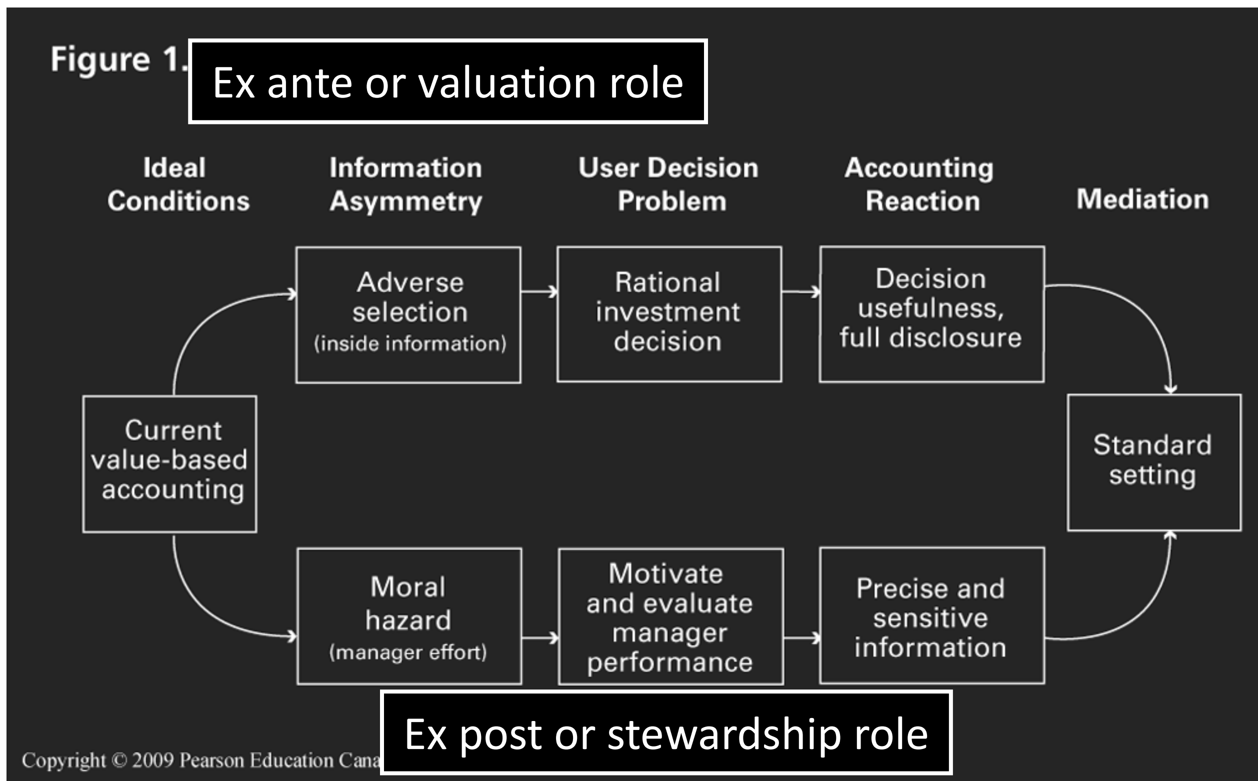

Figure 2: Dual roles of accounting from Scott (2009)

While the valuation role may benefit most from relevant and neutral information, the stewardship role may prefer reliable, verifiable and prudent information. Since moral hazard is often dealt with as best as we can with accounting information based contracts, contract efficiency is also a consideration (see Bauer, O'Brien & Saeed, 2014).

Mora and Walker (2015) conclude that both the analytical and empirical research cannot clearly indicate the conservative or neutral accounting is best. They go on to state: 'the value of accounting conservatism is likely to vary across countries and across firms. It is not safe to assume that either *neutral* or *conservative* financial reporting will be the best form of accounting for all types of firms and for all national contexts. Accounting standards should be framed in a way that will allow firms to explicitly pre-commit to conditionally conservative accounting practices or to neutral accounting practices according to the financial reporting needs of the firm. Financial reporting standards that force all firms to adopt neutral or conservative accounting practices run the risk of causing more harm than good. In addition we would like to see the conceptual framework expanded to explicitly acknowledge the importance of moral hazard and adverse selection as fundamental features of the economic system.' In some ways, they are reiterating something we have known for a long time. Gjesdal (1981) noted that the optimal accounting system depends on the use made of the information.
Basu (2009) furthers: 'Put differently, if conditional conservatism improves contracting efficiency but is not permitted, how do firms and their stakeholders improve their contracting efficiency? Is it by increased disclosure, posting deposits or other bonding devices, getting political or regulatory backing, or some other mechanism? Does the introduction of conditional conservatism reduce reliance on these alternative contracting mechanisms (are they substitutes) or increase reliance on them (are they complements)? More generally, if mandatory

unconditional conservatism preempts conditional conservatism (e.g., R&D accounting in the U.S.), how do affected firms improve their contracting efficiency to compete with unaffected firms?'

7. CONCLUSION

The 2010 Conceptual framework dropped the principle of prudence arguing that it was incompatible with neutrality. Nevertheless, there was and continues to be significant unconditional and conditional prudence in IAS/IFRS (see again Barker and McGeachin, 2015 and extracts in Appendix A). Further, the argument that this was to move towards more fair value accounting is not supported: when excluding financial firms, there is little fair value in most commercial and industrial firms balance sheets (see again Nobes, 2015 and extracts in Appendix B). There was an obvious incoherence between framework and standards.

The new ED/2015/3 May 2015, Conceptual Framework for Financial Reporting is planning to both re-introduce stewardship and prudence in the conceptual framework. As such, it would appear like a return to the pre-2010 framework. Not exactly! In the pre-2010 framework, prudence was linked to reliability (and somewhat to verifiability). It is now very specifically linked to neutrality!

2.18 Neutrality is supported by the exercise of prudence. **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 mis-statements can lead to the overstatement of income or the understatement of expenses in future periods.

Further, the framework argues that there is no need for **asymmetric prudence** as a principal, even though there is much present in current standards. The ED states: 'Policies that treat gains and losses asymmetrically can result in more relevant that faithfully represents what it purports to represent. They can also be neutral: not intended to increase the probability that financial information will be received favourably or unfavourably by users.'

It appears as if the new conceptual framework will continue to be unsatisfactory: few would associate prudence with neutrality, it is unable to clearly explain the current level of both unconditional and conditional conservatism in the standards, and it is not obvious how exactly it will play a role in future standard setting (assuming the conceptual framework's main objective is to do so).

In a framework, everything must be connected. The objectives and qualitative characteristics influence the recognition, measurement and disclosure rules. The European Financial Reporting Advisory Group (EFRAG), the French Autorité des Normes Comptables (ANC), the Accounting Standards Committee of Germany (ASCG), the Organismo Italiano di Contabilità (OIC) and the UK Financial Reporting Council (FRC) in their publication *Getting a Better Framework PRUDENCE Bulletin* (April 2013) note (Item 38) '**prudence**, although widely accepted as a concept, continues to give rise to diverse views, since not everyone today exercises the degree of "caution" in the same way. This variety of views plays a role in the decisions to be made, in

the context of the revisions of the Conceptual Framework, about recognition, measurement, presentation and disclosures. Therefore, it is in our view useful that, in making these decisions, the role of **prudence** is explicitly considered.'

They also recognize a broader role for prudence: (Item 2) 'the essence of **prudence** is that assets and income are not overstated and that liabilities and expenses are not understated. The application of **prudence** ensures that gains are reported only if they are highly probable or reasonably certain (often not until realised) but that (expected) losses are recognised as soon as they are identified. **Prudence** also causes an asymmetry in the accounting for assets and liabilities, as it requires a higher degree of certainty before recognition of assets than of liabilities. **Prudence** may affect the accounting policies that determine whether transactions and events are recognised; the measurement of assets and liabilities that are recognised; and the presentation of gains and losses. It may play a role both in the development of accounting standards and, in practice, the preparation of financial statements based on these standards.'

The Accounting Advisory Forum (XV/7002/95 EN, 1995) remarked that there are different ways in which the **prudence** principle can play a role in a conceptual framework and these could be grouped under three basic headings:

a) Prudence in obtaining an adequate assessment of situations of particular risk.

As economic activities involve risks and uncertainty, prudence should be used in reflecting them in the accounts, in order to give a true and fair view. This reflects itself by, for example, taking into account off-balance sheet items, including notes for contingencies and commitments, and asymmetry of treatment with respect to gains/losses.

b) Prudence reflected in the recognition and valuation of assets and liabilities.

Prudence could play a fundamental role in the recognition of assets and liabilities, by delimiting the circumstances under which certain expenditures can be recognised as assets and by requiring adequate consideration of foreseeable liabilities and potential losses. Prudence could also play an important role in the valuation of assets: the prudence principle would require that assets are shown at a lower value attributable to them at the balance sheet date.

c) Prudence in dealing with profits.

Prudence could plays a role in determining whether profits can be recognised in the profit and loss account and in deciding their destination. Three issues to deal with here. One, profits arising from transactions. This is an issue of realization and matching. Two, increases in value, which ones and where: NI or OCI (recycled or not)? Three, income from other events, e.g., reversals of provisions.

Are overall changes in conceptual framework taking into account prudence? Let's look at assets.

1) Assets to be defined as present economic resources (rights that have a potential to produce economic benefits) controlled by the entity as a results of past events as opposed to

resources controlled by the entity as a results of past events and from which future economic benefits are expected to flow to the entity. It would appear that a potential is less stringent than expected: what does it mean for asset recognition?

2) Recognition of assets was based on 1) meeting definition, 2) economic benefits being probable, and 3) can be measured reliably. ED proposes recognition based on 1) meeting definition, 2) being relevant, 3) faithfully represent, and 4) meeting cost/benefit criteria. It is argued that the information may not be relevant if 1) uncertainty as to existence, 2) low probability of inflow, and 3) high measurement uncertainty. One could argue that framework would suggest using prudence (caution) in the face of such uncertainties.

3) New rules on derecognition proposed. In order to faithfully represent assets retained there should be derecognition if assets are consumed, collected, fulfilled or expired. Not clear how this allows lower or cost or market rules or impairment rules? Nothing to say as to where write-offs should be presented?

4) When it comes to measurement, the CF proposes to use the objectives and qualitative characteristics to determine appropriate basis. The following figure is presented in IFRS documentation:

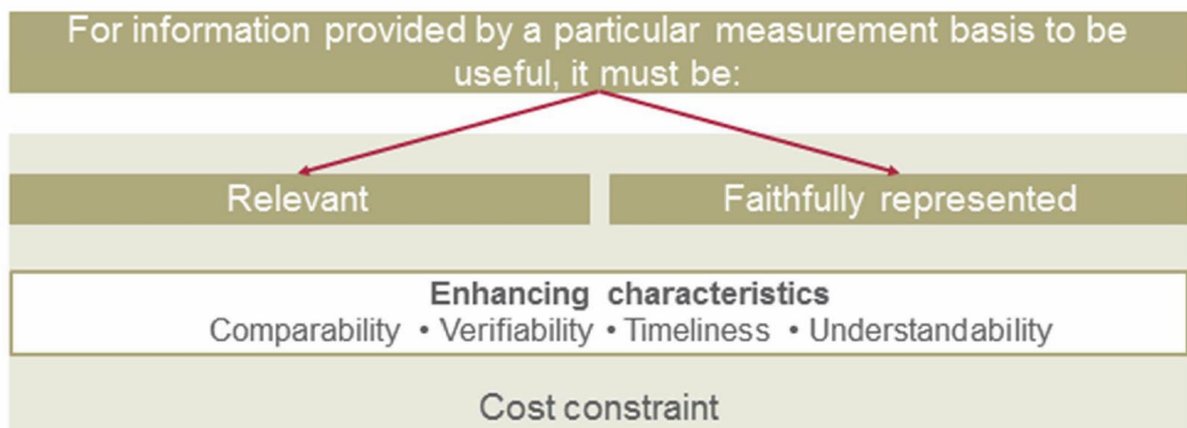

Figure 3: IFRS slides on new conceptual framework

While the CF will argue that prudence helps neutrality (?) and neutrality supports faithful representation, prudence is obviously not at the forefront. Above, it is argued against recognition if we have high measurement uncertainty but in the measurement section it is said that sometimes a measurement with a high degree of uncertainty is the only relevant measurement! This would appear to go against prudence (caution). Why not simply disclose measures with high degrees of uncertainty? Some argue that this allows fair values with high degree of measurement uncertainty to be booked on the balance sheet.

We could easily repeat the exercise with liabilities. In the end, it is not obvious that the current proposed changes to the CF will satisfy most users and preparers. Without arguing for a return to hidden reserves or cookie jar accounting, recognizing a broader role for prudence would better address some of the issues listed above and to everlasting trade-offs in accounting when attempting to meet both the valuation and contracting/stewardship roles. While we know that no set of accounting rules can satisfy all objectives – we already have many accountings: management accounting, tax accounting, prudential/regulatory accounting for banks and insurance companies – since are general purpose financial statements are used for both valuation and contracting, two separate accountings at this level may not be the most cost effective.

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Table 2 ***Definitions of conservatism/prudence***

Author(s)	Definition
Bliss (1924)	The old and **conservative** rule of accounting and business practice is to anticipate no profits and provide for all probable losses.
Gilman (1939)	Recognize all losses, but anticipate no gains
APB Statement #4 (1970)	The uncertainties that surround the preparation of financial statements are reflected in a general tendency toward early recognition of unfavorable events and minimization of the amount of net assets and net income.
SFAC#2 (1980)	A **prudent** reaction to uncertainty to try to ensure that uncertainty and risks inherent in business situations are adequately considered.
IAS#1 (1975)	Uncertainties inevitably surround many transactions. This should be recognized by exercising **prudence** in preparing financial statements. **Prudence** does not, however, justify the creation of secret or hidden reserves.
IASB Framework (2001)	**Prudence** is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of **prudence** does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because the financial statements would not be neutral and, therefore, not have the quality of reliability.
IASB Framework (ED 2015)	**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 mis-statements can lead to the overstatement of income or the understatement of expenses in future periods. No need for asymmetric **prudence** as a principal.
4th Directive (1978)	Valuation must be made on a **prudent** basis, and in particular: d) only profits made at the balance sheet date may be included, e) account must be taken of all foreseeable liabilities and potential losses arising in the course of the financial year concerned or of a previous one, even if such liabilities or losses become apparent only between the date of the balance sheet and the date on which it is drawn up, f) account must be taken of all depreciation, whether the results of the financial year is a loss or a profit.
Directive 2013	Estimates should be based on a **prudent** judgement of the management of the undertaking and calculated on an objective basis, supplemented by experience of similar transactions and, in some cases, even reports from independent experts. Recognition and measurement shall be on a **prudent** basis, and in particular:

	(i) only profits made at the balance sheet date may be recognised, (ii) all liabilities arising in the course of the financial year concerned or in the course of a previous financial year shall be recognised, even if such liabilities become apparent only between the balance sheet date and the date on which the balance sheet is drawn up, and (iii) all negative value adjustments shall be recognised, whether the result of the financial year is a profit or a loss;
Plan comptable general (2015)	La comptabilité est établie sur la base d'appréciations prudentes, pour éviter le risque de transfert, sur des périodes à venir, d'incertitudes présentes susceptibles de grever le patrimoine et le résultat de l'entité.
Basu (1997)	Accountants' tendency to require a higher degree of verification for recognizing good news than bad news in financial statements.
Watts (2003)	Conservatism is defined as the differential verifiability required for recognition of profits versus losses. Its extreme form is the traditional conservatism adage: "anticipate no profit, but anticipate all losses."

Oxford dictionary

Conservative (adjective)

1) **averse to change or innovation and holding traditional values:** ***they were very conservative in their outlook***
2) **(of dress or taste) sober and conventional:** ***a conservative suit***
3) **(in a political context) favouring free enterprise, private ownership, and socially conservative ideas.**
4) **(Conservative) relating to the Conservative Party of Great Britain or a similar party elsewhere:** ***the Conservative government***
5) **(of an estimate) purposely low for the sake of caution:** ***police placed the value of the haul at a conservative £500,000***
6) **(of surgery or medical treatment) intended to control rather than eliminate a condition, with existing tissue preserved as far as possible.**

Prudence (*noun*)

- **the quality of being prudent; cautiousness:** ***we need to exercise prudence in such important matters***

Prudent (*adjective*)

- **acting with or showing care and thought for the future:** ***no prudent money manager would authorize a loan without first knowing its purpose***

Cautious (*adjective*)

- **(of a person) careful to avoid potential problems or dangers:** ***a cautious driver; firms have been unusually cautious about hiring new workers***
- **(of an action) characterized by the desire to avoid potential problems or dangers:** ***the plan received a cautious welcome***

Appendix A: Extract from Barker and McGeachin (2015)

Table 1

CONSERVATISM IN IFRS (EXTANT STANDARDS)

Standard	Probability recognition threshold	Reliable measurement recognition criterion	Description of conservatism identified in standard	Conservatism type
IFRS 15 *Revenue from Contracts with Customers* (2014)	Yes, two probability thresholds: (i) it must be probable that the entity will collect the consideration under the contract (IFRS 15, para. 9(e)); and (ii) variable consideration must be 'highly probable' (IFRS 15, para. 56). The latter is acknowledged in the Basis as causing tension with the objective of neutrality in the Framework (BC207), there is no discussion of conservatism or neutrality relating to the former. Instead, the Basis explains that this is part of identifying whether or not the contract is a valid contract and that the population of contracts that do not meet this criterion is expected to be small.	No	Revenue recognized when performance obligation satisfied, not when activity performed. Performance obligation measured at transaction price with a liability adequacy test, not at current exit price.	Recognition/Unconditional because revenue is not recognized until the performance obligation is satisfied. Also, on initial recognition the contract is not recognized at a neutral amount because no day one gain is recognized. Finally, consideration must be probable or highly probable. Subsequent measurement is conditionally conservative because losses, but not gains, are recognized.
IFRS 13 *Fair Value Measurement* (2011)	N/A	N/A	In terms of how fair value is measured, the objective is a neutral reflection of the market participant's expectations, although there is one exception to this: demand deposits. Whether or not the arguments given for the required treatment are accepted, the final sentence in BCZ103 can only be driven by conservatism: *. . . in many cases, the market price observed for such financial liabilities is the price at which they are originated between the customer and the deposit-taker—i.e., the demand amount. It also noted that recognizing a financial liability with a demand feature at less than the demand amount would give rise to an immediate gain on the origination of such a deposit, which the IASB believes is inappropriate.*	The treatment of demand deposits is recognition/unconditional conservatism—on initial recognition no day one gain is recognized.
IFRS 12 *Disclosure of Interests in Other Entities* (2011)	N/A	N/A	Disclosures are driven by concern about downside risk, and hence are conservative. For example, para. 29(c) requires disclosure of the nature of risks associated with interests in unconsolidated structured entities (emphasis added): *The amount that best represents the entity's maximum exposure to loss from its interests in unconsolidated structured entities, including how the maximum exposure to loss is determined.*	Disclosure

Appendix A: Extract from Barker and McGeachin (2015) cont'd

TABLE 1

CONTINUED

Standard	Probability recognition threshold	Reliable measurement recognition criterion	Description of conservatism identified in standard	Conservatism type
IFRS 9 *Financial Instruments* (2014)	No	No. BC5.17 notes the Board's view that fair value for equity instruments meets the criteria in the Framework to be reliable if appropriate measurement techniques and inputs are employed.	Some financial assets are held at amortized cost and are subject to an impairment test, resulting in measurement conservatism. (On presentation, gains and losses on some equity investments and the effects of changes in credit risk on financial liabilities are recognized in other comprehensive income. This applies to both gains and losses, so it is not conservatism as such, but may reflect users' concerns about the reliability of these amounts.)	Measurement at amortized cost with impairment is conditional conservatism because losses are recognized but gains are not.
IFRS 7 *Financial Instruments: Disclosures* (2009)	N/A	N/A	Some of the disclosures focus solely on potential losses, e.g., those relating to credit risk for financial assets.	Disclosure
IFRS 6 *Exploration for and Evaluation of Mineral Resources* (2004)	No	No	Assets are measured in accordance with IAS 16 (see below) and IAS 36 (see below), but with a relaxation of the requirements to assess impairments at a cash-generating unit level. Hence, measurement is conservative for assets held at cost subject to an impairment test, but less so than would be without relaxation.	Measurement at amortized cost with impairment is conditional conservatism because losses are recognized but gains are not.
IFRS 5 *Non-Current Assets Held for Sale and Discontinued Operations* (2004)	N/A (applies to assets already recognized).	N/A (applies to assets already recognized)	Assets held for sale measured at the lower of carrying amount and fair value less costs to sell, and not depreciated.	This is conditional/measurement conservatism because losses on sale are anticipated, but gains on sale are not.
IFRS 4 *Insurance Contracts* (2004)	No	Impairment of reinsurance assets recognized only if the impairment event has a reliably measurable impact (para. 20b), otherwise silent.	Requires adequacy test for liabilities and impairment test for assets, i.e., includes measurement conservatism. However, it prohibits provisions for non-existent claims (equalization), i.e., reduces recognition conservatism, and, as a general requirement, does not require elimination of excessive prudence, but prohibits its introduction.	The adequacy test for liabilities and impairment test for assets give rise to conditional/measurement conservatism.
IFRS 2 *Share-based payments* (2004)	No	In rare cases, may be unable to estimate the fair value of equity instruments granted. Assumes reliable measurement of cash-settled share-based payments (liabilities).	Recognition of unvested employee benefits. It is acknowledged that in rare cases, the entity may be unable to estimate the fair value of equity instruments granted but reliable measurement of cash-settled share-based payments (liabilities) is assumed.	Recognition/Unconditional—recognition of liabilities that do not yet exist.

Appendix A: Extract from Barker and McGeachin (2015) cont'd

IAS 40 *Investment Property* (2003)	Yes, but not discussed in detail.	Investment property recognized if cost can be measured reliably (para 16). Discussed for exchanges of assets (paras 27 and 29). Fair value must be reliably measurable for fair value model, rebuttable presumption that this is the case (para. 53).	The cost model includes an impairment test, so losses are recognized, but unrealized gains are not.	Measurement at cost with impairment is conditional conservatism because losses are recognized but gains are not.
IAS 39 *Financial Instruments: Recognition and Measurement* (1999)	No	No day one gains or losses unless fair value level 1.	Assets held at amortized cost are subject to an impairment test. Unrealized gains are not recognized, but unrealized losses are.	Measurement at amortized cost with impairment is conditional conservatism because losses are recognized but gains are not.
IAS 38 *Intangible Assets* (2004)	Reliable measurement and probability criteria are combined as follows: Intangible assets recognized if future benefits probable and cost can be measured reliably (para. 21). This will usually be true for separately acquired intangibles (paras 25 and 26) and always true for those acquired in a business combination (para. 33). Reliability (but not probability) discussed for exchanges of assets (paras 45 and 47). Reliable measurement not the case for internally generated goodwill (para 49). Benefits not probable for internally generated research (para. 55). Reliable measurement and probable inflow not always the case for internally generated intangibles (paras 51 and 57).		Recognition criteria applied much more tightly than in IAS 37. Assumptions about internally generated goodwill and internally generated intangibles result in unconditional recognition conservatism. Residual value of intangible assets is assumed to be zero unless there is an active market, resulting in unconditional measurement conservatism. Assets measured at amortized cost are subject to an impairment test.	The non-recognition of some intangibles even if the market ascribes value to them is unconditional conservatism, as is the assumption of zero residual value. The measurement of intangible assets at amortized cost with an impairment test is conditional conservatism.
IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (1998)	Yes, and possibility of non-probable outflows clearly envisaged.	Provision recognized if reliable estimate can be made (para. 14), which is deemed possible except in extremely rare cases (para. 25).	Recognition: liabilities recognized if outflows more likely than not, assets recognized only if inflows virtually certain. Liabilities recognized for constructive obligations and for restructuring costs are recognized before some would argue the liabilities actually exist. Measurement: caution is needed in making judgements under conditions of uncertainty, so that liabilities are not understated. However, uncertainty does not justify deliberate overstatement of liabilities. More extensive disclosure required for contingent liabilities than for contingent assets.	The non-recognition of contingent assets until the inflows are virtually certain is unconditional conservatism.
IAS 36 *Impairment of Assets* (2004)	No	Sometimes not possible to determine fair value less costs to sell reliably (para. 20).	Impairment of historical cost amounts results in conservatism.	Measurement at cost with impairment is conditional conservatism because losses are recognized but gains are not.

Appendix A: Extract from Barker and McGeachin (2015) cont'd

TABLE 1

CONTINUED

Standard	Probability recognition threshold	Reliable measurement recognition criterion	Description of conservatism identified in standard	Conservatism type
IAS 33 *Earnings per Share* (2003)	N/A	N/A	Diluted EPS based ignores antidilutive shares.	Disclosure
IAS 23 *Borrowing Costs* (2007)	Yes, but not discussed in detail, in effect there is an assumption that it is met.	Borrowing costs capitalized if, inter alia, they can be measured reliably (para. 9).	Criteria for capitalization of borrowing costs (including reliable measurement) restricts the amount that can be capitalized, hence is conservative.	The non-recognition of some borrowing costs as part of an asset is unconditional conservatism. (They are not recognized as an asset even if the carrying amount of the asset were they capitalized would not give rise to an impairment loss.)
IAS 20 *Government Grants* (1983)	No	No	Government grants recognized as an asset when reasonable assurance that that grant will be received and conditions met. Also recognized as a liability until income matches expenses, which creates conservatism.	The deferred recognition of government grants both in the balance sheet and in the income statement is unconditional recognition conservatism.
IAS 19 *Employee Benefits* (2011)	No	Profit share and bonus recognized only if liability can be measured reliably (para. 19), which is discussed in para. 22. May be no way to reliably allocate costs of multi-employer plan (para. 36). For defined benefit plans, actuarial methods result in reliable measurement (para. 57).	Liability recognized for unvested benefits post-employment benefits, despite arguments that they do not meet the definition of a liability.	Recognition/Unconditional—recognition of liabilities that do not yet exist.
IAS 18 *Revenue* (1993)	Yes, with brief discussion.	Revenue recognized when probable benefits can be measured reliably (paras 14, 20, 29), and discussion of what to do if no reliable measurement (paras 19 and 28).	Recognized on transfer of risks and rewards of ownership (rather than based on activity).	Delay in revenue recognition is unconditional conservatism.

Appendix A: Extract from Barker and McGeachin (2015) cont'd

IAS 17 *Leases* (1997)	No	Allocation of lease of land and buildings between lease for land and lease for building requires reliable allocation (para. 16).	*Lessees* Finance lease assets initially measured at the lower of fair value and the present value of minimum lease payments and subsequently at a depreciated amount and subject to impairment, hence conservatively measured. *Lessors* Finance lease assets measured at amortized cost. Because they are financial receivables, they are assessed for impairment under IAS 39. Further, any reduction in unguaranteed residual values recognized immediately. These impairment tests cause the accounting to be conservative. *Sale and leaseback transactions* Profit on sale and finance leaseback deferred and amortized over lease term, i.e., deferred recognition of increase in value of the asset, i.e., conservative recognition.	The measurement of lease assets for both lessees and lessors is conditional conservative. The non-recognition of profit on sale and leaseback is unconditional conservatism.
IAS 16 *Property, Plant and Equipment* (2003)	Yes, with brief discussion.	Cost recognized as an asset if it can be measured reliably (para. 7). Discussed in context of exchange of assets (paras 24 and 26). Revaluation model requires fair value to be reliably measurable (para. 31).	Choice of cost with impairment model or revaluation model. The former creates measurement conservatism, the latter presentation conservatism because gains (and subsequent losses) above historical cost are recognized in other comprehensive income rather than profit or loss.	Measurement at cost with impairment is conditional conservatism because losses are recognized but gains are not. Also presentation conservatism.
IAS 12 *Income Taxes* (1996)	Yes. Assumed to be met for deferred tax liabilities, substantial discussion of when it might be met (or not) for deferred tax assets.	Benefit of tax loss used to recover past tax can be measured reliably (para. 14). Reliable determination of timing of reversals often not possible, and so no discounting (para. 54).	Deferred tax assets are recognized only if it is probable that taxable profits will be available against which they can be used whereas deferred tax liabilities have no such recognition criterion. However, this just reflects the fact that the asset may not be recoverable otherwise, whereas the liability will always be payable (at least under the assumptions that support the temporary difference model).	None
IAS 11 *Construction Contracts* (1993)	Yes	Yes and guidance on when and what to do if outcome cannot be estimated reliably.	In measuring contracts, expected profits are recognized pro-rata, but expected losses are recognized immediately.	Not recognizing expected profits on initial recognition is unconditional conservatism. Subsequent measurement is conditionally conservative.
IAS 2 *Inventories* (2003)	No	No	Inventory is measured at the lower of cost and net realizable value.	This is conditional measurement conservatism.

Table 1 reports the requirements for conservative accounting practice in IFRS, for each accounting standard where such practice is applicable. The table also includes columns that show the extent to which the standard includes the two recognition criteria from the Conceptual Framework. This is useful information in assessing whether IFRS are conservative because it allows a comparison of the application of these criteria across different standards, to see whether they are applied differently to assets and liabilities. The following accounting standards do not exhibit conservatism or include any related issues of note and are therefore excluded from Table 1: IFRS 1, 8, 10, 11; IAS 1, 7, 8, 21, 24, 29, 32, 34.

Appendix A: Extract from Barker and McGeachin (2015) cont'd

TABLE 2

CONSERVATISM IN IASB PROPOSALS (THE LATEST PROPOSALS IN PAUSED, DEFERRED, AND STOPPED PROJECTS)

Proposal	Probability recognition threshold	Reliable measurement recognition criterion	Description of conservatism identified in standard	Conservatism type
Leases ED (2010)	Yes, for options to extend or cancel leases	No	*Lessees* Less conservative than IAS 17 because lessee assets can be revalued. But they do not have to be, so conservatism still present. Amortization plus interest expense may be back-end loaded, depending on amortization method proposed (still to be decided). *Lessors* *Sale and leaseback transactions:* Sale (and hence profit) only recognized if conditions met, consistent with conservative revenue recognition.	The measurement of lease assets for both lessees and lessors is conditional conservatism. The non-recognition of profit on sale and leaseback is unconditional conservatism.
Insurance contracts ED (2010)	No	No	No recognition of day one gains, hence contract liability measured conservatively.	The non-recognition of gains on initial recognition is unconditional conservatism.
IAS 37 EDs (2005 and 2010)	No	Yes, but stated to be met except in rare cases	Liabilities: no probability recognition threshold, hence more conservative than IAS 37. Measurement: caution is needed in making judgements under conditions of uncertainty, so that liabilities are not understated. However, uncertainty does not justify deliberate overstatement of liabilities.	Lack of probability threshold makes the treatment of liabilities neutral.
Extractive Industries ED (project team views, not necessarily those of the IASB) (2010)	No	No	Users do not find fair value accounting useful because of the subjectivity and degree of estimation required.	Measurement at cost with impairment is conditional conservatism because losses are recognized but gains are not.
Tax ED (2010)	Yes, for deferred tax assets	Exception to deferred tax recognition of some temporary differences from subsidiaries justified by lack of reliable measurement.	Change in justification for exception to recognizing deferred tax on some temporary differences relating to investments in subsidiaries to one based on reliability of measurement.	None

Table 2 reports the requirements for conservative accounting practice in IASB proposals. The following proposals do not exhibit conservatism or include any related issues of note and are therefore excluded from Table 2: Hedging ED (2010), Pensions DP (2008), Framework Reporting Entity (2010), Investment Entities ED (2011), EPS ED (2008), and Financial Statement Presentation ED (2010).

Appendix B: Extract from Nobes (2015)

Table 2. Fair value measurement in IFRSs

Standard and paragraph	Title of standard	'FV basis' required	'FV basis' or similar allowed	FV for initial measurement	FV (or similar) when lower than cost basis
IFRS 1 (App. D)	First-time adoption of IFRSs	-	-	Option to use FV as deemed cost	-
IFRS 2 (paras. 10, 30)	Share-based payment	For cash-settled payments, FV of liability	-	For equity-settled, FV of goods received or instruments granted	-
IFRS 3 (paras. 18, 37)	Business combinations	-	-	Assets and liabilities in business combinations, and the consideration	-
IFRS 4	Insurance contracts	-	-	-	-
IFRS 5 (para. 15)	Non-current assets held for sale and discontinued operations	-	-	-	Lower of cost or FV less costs to sell
IFRS 6 (para. 12)	Exploration for and evaluation of mineral resources	-	Exploration an[d] evaluation assets	-	See IAS 36
IFRS 7	Financial instruments: disclosures	-	-	-	-
IFRS 8	Operating segments	-	-	-	-

Standard and paragraph	**Title of standard**	**'FV basis' required**	**'FV basis' or similar allowed**	**FV for initial measurement**	**FV (or similar) when lower than cost basis**
IFRS 9 (paras. 5.1.1 5.2.1)	Financial instruments	Instruments excep those with certai business models an cash flows	Designated instruments	All instruments excep trade receivables	-
IFRS 10 (para. 31)	Consolidated financial statements	Subsidiaries of investment entities	-	-	-
IFRS 11	Joint arrangements	-	-	-	-
IFRS 12	Disclosure of interests in other entities	-	-	-	-
IFRS 13	Fair value measurement	-	-	-	-
IFRS 14	Regulatory deferral accounts	-	-	-	-
IFRS 15 (para. 66)	Revenue from contracts with customers	-	-	Non-cash revenue	-
IAS 1	Presentation of financial statements	-	-	-	-
IAS 2 (para. 3)	Inventories	-	Inventories of minera producers an commodity traders	-	Inventory at lower of cost or net realisable value
IAS 7	Statement of cash flows	-	-	-	-
IAS 8	Accounting policies, changes in accounting estimates and errors	-	-	-	-
Standard	**Title of standard**	**'FV basis' required**	**'FV basis' or similar allowed**	**FV for initial measurement**	**FV (or similar) when lower than cost basis**

and paragraph					
IAS 10	Events after the reporting period	-	-	-	-
IAS 11 (para. 12)	Construction contracts (being replaced by IFRS 15)	-	-	Revenue	-
IAS 12	Income taxes	-	-	-	-
IAS 16 (paras. 24, 29)	Property, plant and equipment	-	PPE	Assets acquired by exchange	See IAS 36
IAS 17 (para. 20)	Leases	-	-	FV of finance lease asset if lower than DCF of lease liability	See IAS 36
IAS 18 (para. 9)	Revenue (being replaced by IFRS 15)	-	-	Revenue	-
IAS 19 (para. 57)	Employee benefits	Plan assets	-	-	-
IAS 20 (para. 23)	Accounting for government grants and disclosure of government assistance	-	-	Non-monetary grant	-
IAS 21	The effects of changes in foreign exchange rates	-	-	-	-
IAS 23	Borrowing costs	-	-	-	-

Standard and paragraph	Title of standard	'FV basis' required	'FV basis' or similar allowed	FV for initial measurement	FV (or similar) when lower than cost basis
IAS 24	Related party disclosures	-	-	-	-
IAS 26 (para. 32)	Accounting and reporting by retirement benefit plans	Plan assets	-	-	-
IAS 27 (para. 10)	Separate financial statements	-	Investments treated under IAS 39 or IFRS 9	-	-
IAS 28 (para. 18)	Investments in associates and joint ventures	-	Associates or joint ventures held by venture capitalists etc	-	-
IAS 29	Financial reporting in hyperinflationary economies	-	-	-	-
IAS 32 (para. 31)	Financial instruments: presentation	-	-	Liability component o compound instrument	-
IAS 33	Earnings per share	-	-	-	-
IAS 34	Interim financial reporting	-	-	-	-
IAS 36 (paras. 6, 59)	Impairment of assets	-	-	-	FV less selling costs is one basis for impaired assets

Standard and paragraph	Title of standard	'FV basis' required	'FV basis' or similar allowed	FV for initial measurement	FV (or similar) when lower than cost basis
IAS 37	Provisions, contingent liabilities and contingent assets	-	-	-	-
IAS 38 (paras. 45, 72)	Intangible assets	-	Unusual intangibles wit an active market	Assets acquired b exchange	See IAS 36
IAS 39 (paras. 9, 43, 47)	Financial instruments: recognition and measurement (being replaced by IFRS 9)	Trading, derivative and available for sale instruments	Designated instruments	All instruments	-
IAS 40 (paras. 27, 30)	Investment property	-	Investment property	Assets acquired b exchange	If using cost basis, see IAS 36
IAS 41 (paras. 2, 12, 13)	Agriculture	Biological assets (except bearer plants) at FV less costs to sell	-	Agricultural produce	-

Appendix C

Extract: The Concept of Prudence: dead or alive? FEE Conference on Corporate Reporting of the Future, Brussels, Belgium, Tuesday 18 September 2012
Hans Hoogervorst, Chairman of the IASB

There are two problems with excessive **conservatism**. First of all, during an economic upturn, profits are artificially depressed and investors might miss out on a good investment opportunity. But the biggest problem kicks in during the downswing of the economic cycle. In those circumstances, hidden reserves can be used to artificially increase an entity's earnings. Profits are overstated, masking the deterioration of the entity's performance. Again, the casualty is transparency. The investor is likely to be misled and might be induced to hold on too long to his investments. More generally, cookie jar accounting undermines confidence in the reliability of financial reporting.

It is also easy for me to accept the revised Conceptual Framework since the old concept of **Prudence** –if in doubt, be cautious- is still very much engrained in our standards. Let me just give you a few examples:

- While fair values are often seen to be synonymous with exuberance, in IFRS 13we actually require risk adjustments when fair values are measured using mark-to-model techniques.
- Our standards require liabilities to be recorded for guarantees or warranties, even when they have not yet been called in.
- Inventory is typically carried at lower of cost or net realisable value; again a prime example of exercising caution.
- Impairment tests are required to ensure that the carrying amount in the statement of financial position is not greater than the recoverable amount of the asset
- IFRSs also have very strict rules governing the balance sheet presentation, giving little room for off-balance sheet financing.
- As is well known, our standards are quite restrictive in terms of the netting of derivatives. The difference with entities reporting under US GAAP can be as big as 30 or 40% of the balance sheet. We believe derivatives are too important –and their net positions too volatile-to be relegated to the notes.
- The upcoming leasing standard is another effort to make off-balance sheet financing more transparent. Analysts around the world routinely adjust the balance sheet for leases that they perceive to be off-balance sheet financing. It is highly prudent that we are going to enshrine this in our standards.
- Equally, our consolidation rules, based on the principle of control are very strict. Rather than choosing for a bright line, we opted for a qualitative principle which may require consolidation, even if a company's interest is less than 50%.

Appendix D: Extracts from Ruch and Taylor (2014)

Table 3: Studies on Financial Statement Effects

Author(s)	Topic	Research Question	Sample	Type of Conservatism	Findings
Penman and Zhang (2002)	Time-Series Properties of Earnings	What effect do conservative accounting practices have on earnings quality?	US firms (1975-1997)	Unconditional	Conservatism results in the accumulation of "hidden reserves". These reserves are released into earnings when temporary changes are made to conservative accounting. This results in earnings that are less predictable.
Kim and Kross (2005)	Time-Series Properties of Earnings	Has the ability of earnings to predict future operating cash flows improved over time?	US firms (1972-2001)	Conditional	The ability of earnings to predict operating cash flows has increased over the sample period. This increase appears to be driven by the previously documented time-series increase in accounting conservatism.
Dichev and Tang (2008)	Time-Series Properties of Earnings	Has the ability of expenses to match revenues declined over time?	US firms (1967-2003)	Conditional	Revenue-expense matching has decreased over time, resulting in more volatile and less persistent earnings. This suggests that expense recognition is timelier, consistent with conditional conservatism.
Bandyopadhyay et al. (2010)	Time-Series Properties of Earnings	How does the ability of earnings to predict future operating cash flows affect the ability of earnings to predict future earnings?	US firms (1972-2006)	Conditional	Conservatism enhances the ability of earnings to predict future operating cash flows, but inhibits the ability of earnings to predict future earnings.
Jackson and Liu (2010)	Earnings Management	How does conservative accounting with respect to the allowance for doubtful accounts impact the ability of firms to manage earnings using bad debt expense?	US firms (1980-2004)	Unconditional	Bad debt expense is managed to meet earnings targets. Conservative treatment of allowance for doubtful accounts facilitates the use of bad debt expense to manage earnings.
Chen et al. (2013)	Time-Series Properties of Earnings	How does conservatism affect earnings persistence and stock pricing multiples?	US firms (1988-2010)	Conditional	Conservatism reduces earnings persistence, and in turn, reduces equity pricing multiples. Results do not hold for conservatism using continuous variables.

Appendix D: Extracts from Rich and Taylor (2014) cont'd

Table 4, Panel A: Studies on the Effects on Equity Market Users (Value Relevance)

Author(s)	Topic	Research Question	Sample	Type of Conservatism	Findings
Collins et al. (1997)	Value Relevance	Has the value relevance of earnings and book value decreased over the past forty years?	US firms (1953-1993)	Not specified	Value relevance of earnings has decreased over time. The decrease is attributed to an increase in one-time charges, negative earnings, and intangible intensity.
Francis and Schipper (1999)	Value Relevance	Has the value relevance of financial statements decreased over time?	US firms (1952-1994)	Not specified	Value relevance of earnings has declined over time. Decrease cannot be attributed to an increase in high-technology firms.
Lev and Zarowin (1999)	Value Relevance	Has the usefulness of financial reporting declined over the past twenty years?	US firms (1977-1996)	Not specified	The association between earnings and returns has declined over time. This decreased association is particularly large for firms with increasing R&D intensity.
Monahan (2005)	Value Relevance	How does conservative accounting for R&D expenditures impact valuations using the residual income valuation model?	US firms (1988-1998)	Unconditional	Equity valuations using the RIV model of firms with high R&D and high R&D growth are less accurate than those of firms with low R&D or low R&D growth.
Balachandran and Mohanram (2010)	Value Relevance	Is conservatism driving the previously documented decline in value relevance?	US firms (1975-2004)	Unconditional	There is insufficient evidence to conclude that accounting conservatism is driving the decrease in value relevance over time.

Appendix D: Extracts from Rich and Taylor (2014) cont'd

Table 4, Panel B: Studies on the Effects on Equity Market Users (Information Asymmetry)

Author(s)	Topic	Research Question	Sample	Type of Conservatism	Findings
LaFond and Watts (2008)	Information Asymmetry	Is information asymmetry caused by conservatism?	US firms (1983-2001)	Conditional	The differential timeliness of bad news and good news recognition is greater in the presence of information asymmetry. Changes in information asymmetry lead conservatism, indicating that conservatism arises from information asymmetry.
Hui et al. (2009)	Information Asymmetry	How does accounting conservatism impact voluntary disclosure?	US firms (1991-2002)	Conditional; Unconditional	Conservatism is negatively associated with the frequency of management earnings forecasts. Conservatism reduces the need to disclose bad news, as it mitigates information asymmetry.
Francis et al. (2013)	Information Asymmetry	Did firms that exhibited a high degree of conditional conservatism experience smaller market value losses during the financial crisis?	US firms (1980-2009)	Conditional; Unconditional	Firms exhibiting more conservatism prior to the financial crisis suffered smaller losses during the financial crisis than firms exhibiting less conservatism prior to the financial crisis.
Kim et al. (2013)	Information Asymmetry	Does conditional conservatism mitigate the negative market reaction of seasoned equity offerings?	US firms (1989-2008)	Conditional	SEO announcement returns are positively related to the degree of accounting conservatism and that the negative association between information asymmetry and SEO announcement returns in mitigated in the presence of conservatism.

Appendix D: Extracts from Rich and Taylor (2014) cont'd

Table 4, Panel C: Studies on the Effects on Equity Market Users (Equity Cost of Capital)

Author(s)	Topic	Research Question	Sample	Type of Conservatism	Findings
Francis et al. (2004)	Equity Cost of Capital	What earnings attributes result in a lower equity cost of capital?	US firms (1975-2001)	Conditional	There is no significant evidence to indicate that conservatism affects equity cost of capital.
Chan et al. (2009)	Equity Cost of Capital	How does accounting conservatism affect equity cost of capital? How does the effect differ on the type of conservatism?	UK firms (1987-1999)	Conditional; Unconditional	Unconditional conservatism is associated with a lower cost of equity capital and conditional conservatism is associated with a higher cost of equity capital.
Garcia Lara et al. (2011)	Equity Cost of Capital	What is the relationship between conditional conservatism and equity cost of capital?	US firms (1975-2003)	Conditional	There is a negative association between conditional conservatism and equity cost of capital.

Appendix D: Extracts from Rich and Taylor (2014) cont'd

Table 4, Panel D: Studies on the Effects on Equity Market Users (Analyst Forecasts)

Author(s)	Topic	Research Question	Sample	Type of Conservatism	Findings
Helbok and Walker (2004)	Analyst Forecasts	Is conservative accounting the cause of optimistically biased analyst forecasts?	UK firms (1990-1998)	Conditional	The optimistic bias in analyst forecasts is due to the fact that analysts fail to account for the conservative treatment of news content between the initial forecast and the earnings announcement. Analysts adjust their forecasts in response to good news and bad news as it become available.
Mensah et al. (2004)	Analyst Forecasts	How does accounting conservatism affect analyst forecast accuracy and dispersion?	US firms (1987-1999)	Unconditional	Conservatism is positively associated absolute value forecast error and dispersion. However, results are mixed when conservatism measure is altered in sensitivity analysis.
Louis et al. (2008)	Analyst Forecasts	Do analysts incorporate currently available information related to accounting conservatism into their forecasts?	US firms (1990-2006)	Conditional	Negative and significant relationship between conservatism measured at the end of the prior period and forecast error in the subsequent period, suggesting that analysts do not incorporate available information about conservatism into their forecasts.
Pae and Thornton (2010)	Analyst Forecasts	Do analysts incorporate currently available information related to accounting conservatism into their forecasts?	US firms (1984-2002)	Conditional	Analysts do not efficiently incorporate the asymmetric recognition of news into their forecasts.

Appendix D: Extracts from Rich and Taylor (2014) cont'd

Table 5: Studies on the Effects on Debt Market Users

Author(s)	Topic	Research Question	Sample	Type of Conservatism	Findings
Ahmed et al. (2002)	Debt Markets	Does conservatism mitigate bondholder-shareholder conflict and result in lower debt cost of capital?	US firms (1987-1998)	Conditional; Unconditional	Conservatism is positively associated with proxies for bondholder-shareholder conflict. Conservatism is negatively associated with debt cost of capital. Findings indicate that conservatism arises from bondholder-shareholder conflict and acts to lower debt cost of capital.
Zhang (2008)	Debt Markets	Does conservatism identify default risk in a timelier manner? Does conservatism reduce debt cost of capital?	US firms (1999-2000)	Conditional; Unconditional	Conservatism provides timely information about default risk to lenders, which results in lower debt cost of capital for borrowers.
Wittenberg-Moerman (2008)	Debt Markets	Do analysts incorporate currently available information related to accounting conservatism into their forecasts?	US firms (1990-2006)	Conditional	Negative and significant relationship between conservatism measured at the end of the prior period and forecast error in the subsequent period, suggesting that analysts do not incorporate available information about conservatism into their forecasts.
Gigler et al. (2009)	Debt Markets	Does conservatism result in efficient debt contracting?	Analytical Model	Not specified	Optimal debt contracting arises when Type I and Type II errors are minimized, and not when debt cost of capital is minimized.

Appendix D: Extracts from Rich and Taylor (2014) cont'd

Table 6: Studies on the Effects on Corporate Governance Users

Author(s)	Topic	Research Question	Sample	Type of Conservatism	Findings
O'Connell (2006)	Executive Compensation	How does the sensitivity of executive compensation to accounting earnings differ in "good news" years and "bad news" years?	UK firms (1984-1997)	Conditional	Earnings changes impact compensation changes significantly more in years with positive returns (i.e., good news) than in years with negative returns (i.e., bad news).
Ahmed and Duellman (2007)	Corporate Governance Metrics	Is conservatism associated with corporate governance metrics that reduce agency costs?	US firms (1999-2001)	Conditional; Unconditional	Conservatism is positively associated with the percentage of outside directors' shareholdings and negatively related to the percentage of inside directors on the board. This provides evidence that conservatism reduces agency costs and improves corporate governance.
Garcia Lara et al. (2009)	Corporate Governance Metrics	Do firms with strong corporate governance exhibit a greater degree of accounting conservatism than firms with weak corporate governance?	US firms (1992-2003)	Conditional	High governance firms exhibit a greater degree of asymmetric timeliness. This indicates that the degree of conditional conservatism is positively associated with corporate governance metrics.
Francis and Martin (2010)	Financial Decisions	Does conservative reporting (i.e., timely loss recognition) cause management to make acquisitions that are more profitable?	US firms (1980-2006)	Conditional	Asymmetric timeliness of earnings is positively associated with expected acquisition profitability. This association is more pronounced for firms with high ex ante agency costs.

Appendix D: Extracts from Rich and Taylor (2014) cont'd

Table 6 (Continued): Studies on the Effects on Corporate Governance Users

Author(s)	Topic	Research Question	Sample	Type of Conservatism	Findings
Iyengar and Zampelli (2010)	Executive Compensation	How does accounting conservatism impact the sensitivity of executive compensation to accounting earnings?	US firms (1994-2003)	Conditional	Accounting conservatism significantly increases the association between changes in earnings and changes in compensation.
Kravet (2010)	Financial Decisions	Does conservative reporting (i.e., timely loss recognition) reduce management's incentive to make risky investments?	US firms (1984-2006)	Conditional	Accounting conservatism is negatively associated with the riskiness of acquisitions. This association is present in acquisitions that are perceived to be profitable, suggesting that conservatism constrains management's incentive to make risky investments, even if those investments are profitable.
Ahmed and Duellman (2011)	Financial Decisions	Is conservatism associated with positive future performance?	US firms (1989-2001)	Not specified	Firms that exhibit more conservatism to have higher future profitability than firms that exhibit less conservatism.
Louis et al. (2012)	Financial Decisions	Does accounting conservatism increase the value of cash holdings?	US firms (1974-2006)	Conditional	The market value of cash holdings is greater in the presence of conservatism, which suggests that conservatism is associated with more efficient use of cash holdings.