

# HAS THE ABSENCE OF PRUDENCE FROM THE IFRS CONCEPTUAL FRAMEWORK ISSUED IN 2010 MODIFIED THE CONSERVATIVE PRESENTATION OF FINANCIAL REPORTS OF LISTED COMPANIES? THE CASE OF ROMANIA

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**ABSTRACT:** *Prudence, a controversial accounting concept, is often debated in the research literature through conceptual depictions, analyses of the regulatory process, norms or empirical tests. In this study, our emphasis is on the recourse to prudence in preparing the annual financial statements of Romanian listed entities subsequent to the elimination in 2010 of the notion of prudence from the IFRS Conceptual Framework issued in 2010. Two types of financial information were considered relevant for the analysis of the recourse to prudence: the provisions and the impairment/write-down of assets. The period taken into consideration is 2010-2016 and the sample is comprised of 13 listed companies on the Bucharest Stock Exchange (BSE) from 5 important industry sectors in Romania. Our findings indicate that the elimination of prudence did not affect the way and the method of presentation of the provisions and of the impairment/write-down of assets in the financial statements of listed companies in Romania.*

**KEYWORDS:** *prudence, norm, conservatism, financial statements, International Financial Reporting Standards*

**JELCODE:** *M 21; M 41; M 48*

## 1. INTRODUCTION

The presence of prudence in accounting is associated with the recognition of expenses and liabilities as soon as possible, even before they actually incur, but the postponement of recognition of revenues and assets until they are realized.

The most important reason for addressing prudence is that the exercise of prudence affects the financial performance and it is linked to assertions regarding creditors' protection, since the profit disclosed in the financial statements represents the amount available for distribution among investors, creditors and other stakeholders.

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Until 2010, the financial reporting in accordance with the International Financial Reporting Standards (IFRS) was prepared in terms of prudence, this concept being mentioned in the IASB Conceptual Framework 2001 among the qualitative characteristics of useful financial information. It is worth pointing out that the main purposes of the Conceptual Framework are ‘to assist the IASB in developing and revising IFRSs that are based on *consistent concepts*, to help preparers to develop *consistent accounting policies* for areas that are not covered by a standard or where there is choice of accounting policy, and to assist all parties to understand and interpret IFRS’ (Conceptual Framework, SP1.1). Under these circumstances, before September 2010, the presence of prudence in the Conceptual Framework would have led to *prudent international financial reporting standards* and *prudent accounting policies* approved by the companies that applied the IFRS.

In September 2010, the concept of prudence was eliminated from the Conceptual Framework and the president of IASB explained this decision by referring to the fact that prudence was used in practice many times under the pretext of ‘smoothing’ the reported earnings in order to achieve certain goals. Also, another reason for eliminating prudence was to ensure convergence with the US GAAP, which do not provide a definition for prudence.

The absence of prudence from the 2010 Conceptual Framework was also argued in terms of neutrality, since the concept of caution would be incompatible with the concept of neutrality.

Professionals of different international and European bodies involved in the regulation process did not hesitate to react to this important change in the Conceptual Framework. Therefore, a short review of these opinions is relevant in order to better understand the recent developments and the new approach related to the concept of prudence published in 2018.

The European Financial Reporting Advisory Group (EFRAG), along with the national authorities involved in the accounting regulatory process from France, Germany, Italy and United Kingdom issued a document for public consultation aiming to stimulate debates within Europe as IASB works on developing the revised framework. The focus was on prudence, as a major part of the financial reporting process. Three main views were highlighted: (1) ‘prudence should always prevail over the other qualitative characteristics in the Conceptual Framework’; (2) ‘as long as you meet these characteristics, you do not need to worry about prudence’; and (3) ‘an appropriate balance needs to be struck’ (EFRAG 2013).

The Association of Chartered Certified Accountants (ACCA) also summarized the debates about the importance of prudence in IFRS Conceptual Framework and concluded that ‘there are many examples of prudence in existing IFRS and that these instances are widely accepted treatments’ and that prudence should be reintroduced in the framework since its main role in standard setting ‘lies in robust recognition criteria for assets and liabilities, where its application is transparent’ (ACCA 2014).

In the views of the Federation of European Accountants – FEE (renamed Accountancy Europe since December 2016), prudence should not be seen as a primary factor in developing financial reporting standards and its role should be limited to a general exercise of caution. FEE suggested the term of ‘quality prudence’ as prudence that ‘does not come at the expense of relevance and transparency of information’ (FEE 2014).

The Institute of Chartered Accountants in England and Wales (ICAEW) believes that prudence is a concept used by normalizers and auditors, producers of financial information and their users, therefore it is necessary to have it in the conceptual framework (ICAEW 2013).

From the point of view of the Austrian Financial Reporting and Auditing Committee (AFRAC), prudence should be a general principle in the Conceptual Framework, referring to the exercise of a certain degree of caution, thus being used as a basis for individual rules of the standards (AFRAC 2013).

Being an independent international group of experts in accounting, IASB could not remain indifferent to the views advocated by other professionals in national/European accounting bodies. The echoes of the debates arising from the elimination of prudence from IFRS Conceptual Framework were taken into consideration by IASB and took the shape of an Exposure Draft on the Conceptual Framework for Financial Reporting, issued in 2015. Through this Exposure Draft, IASB decided to explain the role of prudence in financial reporting. Thus, the main objective was to explicitly reintroduce the concept of prudence (described as caution in the exercise of judgments under conditions of uncertainty) and to emphasize the importance of prudence in achieving neutrality. Three years later, IASB finalized the Conceptual Framework for Financial Reporting and its new version was published in May 2018, along with Amendments to references to the Conceptual Framework in IFRS standards. However, these updated references will become effective for annual periods beginning on or after 01 January 2020.

Between 2010-2018, prudence was absent from the text of the IFRS Conceptual Framework. Still, although the term 'prudence' was removed from the conceptual framework in 2010, the IASB argued that prudence continues to be present through the provisions of its standards.

## **2. METHODOLOGICAL APPROACH. RESEARCH OBJECTIVES, SAMPLE SELECTION AND DATA COLLECTION**

Our contribution to the topic of the exercise of prudence in financial reporting is focused on the following *research objective*: to identify whether the elimination of prudence from the Conceptual Framework 2010 has led to changes in the way prudence is reflected in the annual reports. We believe that the exercise of prudence can be addressed by studying the provisions and impairment/write-down of assets in the financial statements in the context of the risks affecting the surveyed companies.

Our research is focused on Romanian entities listed on Bucharest Stock Exchange (BSE) and covers the period 2010-2016, respectively the financial years subsequent to the elimination of the concept of prudence from the Conceptual Framework published in 2010. Out of the 87 companies listed on the exchange segment of BSE, our study analysed 13 companies and the reasons for selecting them are described as follows: first, we eliminated the financial institutions, due to the specificity of their operations; second, we took into consideration that all the surveyed companies were listed throughout the entire analysed period; third, since our intention is to analyse the exercise of prudence in relation to the risks specific to each field of industry, we eliminated the sectors with 2 or less than 2 listed entities. The sampled companies are presented below (Table 1):

Table 1. Presentation of the sample by industry

Industry	Name of the company	Symbol on BSE
Extractive Industry	OMV Petrom S.A.	SNP
	S.N.G.N. Romgaz S.A.	SNG
	Rompetrol Well Services S.A.	PTR
Manufacturing Industry	Biofarm S.A.	BIO
	Antibiotice S.A.	ATB
	Rompetrol Rafinare S.A.	RRC
Constructions	Impact Developer & Contractor S.A.	IMP
	Compania Energopetrol S.A.	ENP
	Transilvania Constructii S.A.	COTR
Hotels and Restaurants	Turism Felix S.A.	TUFE
	Turism, Hoteluri, Restaurante Marea Neagra S.A.	EFO
Transport and Storage	S.N.T.G.N. Transgaz S.A.	TGN
	Socep S.A.	SOCP

*Source: authors' presentation of the analysed companies*

Romanian listed entities have the obligation to prepare their annual individual financial statements in accordance with the International Financial Reporting Standards (IFRS) since 2012. The first annual individual financial statements prepared by Romania entities in accordance with IFRS for the year 2012 include the restated financial information for the years 2010 and 2011, in order to ensure compliance with the requirements of the standard IFRS1 'First-time adoption of International Financial Reporting Standards'. In this way, the financial statements prepared for 2012 also present comparative figures of assets, liabilities and equity at 31 December 2010 and 31 December 2011.

For each of the surveyed entities, we analysed the information about provisions, impairment of assets and write-down of assets, in close relation with the risks associated to the activity, disclosed in the annual individual financial statements published during 2010-2016. The financial statements were available on the websites of the entities and on the website of the Bucharest Stock Exchange. Data was manually collected from the financial statements of the entities; both qualitative (content analyses, in-depth analyses) and quantitative research methods were used in order to answer to our research objective.

As we know, financial reporting is far from an exact science. In preparation of financial reporting, the judgement of the preparers is highly important.

In the Conceptual Framework, prudence was presented as 'the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated' (IASB 1989).

Does the replacement of the concept of Prudence with the concept of Neutrality in the Conceptual Framework in September 2010 lead to a judgement on the side of optimism?

### 3. FINDINGS

In order to achieve the main objective of our research, our first focus was on marking out the presence of provisions in the financial statements of the analysed entities subsequent to the elimination of prudence from the Conceptual Framework published in 2010 and on observing the evolution of provisions as a characteristic of prudence, taking into account the risks that impact on the activity of the entities.

The types of provisions recognised in each industry and the frequency of companies that report these provisions is presented in the table below:

*Table 2. Types and frequency of provisions by industry during 2010-2016*

Industry	Type of provision	Frequency (number of entities)						
		2010	2011	2012	2013	2014	2015	2016
Extractive Industry	Provisions for pensions and similar obligations	2	2	2	2	2	2	2
	Provisions for the decommissioning and restructuring costs	2	2	2	2	2	3	3
	Provisions for litigation	1	1	1	1	1	1	0
	Provisions for profit sharing payable to employees	1	1	1	1	1	0	0
	Other provisions	3	3	3	3	3	3	3
<b>Subtotal for the Extractive industry</b>		<b>9</b>	<b>9</b>	<b>9</b>	<b>9</b>	<b>9</b>	<b>9</b>	<b>8</b>
Manufacturing Industry	Provisions for pensions and similar obligations	3	3	3	3	2	2	2
	Provisions for taxes	0	1	1	1	0	0	0
	Provisions for environment	1	1	1	1	1	1	1
	Provisions for litigation	0	0	0	0	1	0	0
	Provisions for profit sharing payable to employees	1	1	1	0	0	0	0
	Other provisions	1	1	1	1	2	2	2
<b>Subtotal for the Manufacturing industry</b>		<b>6</b>	<b>7</b>	<b>7</b>	<b>6</b>	<b>6</b>	<b>5</b>	<b>5</b>
Construction	Provisions for taxes	1	1	1	1	1	1	1
	Provisions for	2	2	2	2	2	2	1

Provisions	guarantees to customers							
	Provisions for litigation	0	0	1	1	1	1	0
	Provisions for profit sharing payable to employees	1	1	1	1	1	1	1
	Other provisions	0	0	1	1	1	1	1
<b>Subtotal for Constructions</b>		<b>4</b>	<b>4</b>	<b>6</b>	<b>6</b>	<b>6</b>	<b>6</b>	<b>4</b>
Hotels and Restaurants	Provisions for pensions and similar obligations	0	0	1	1	1	1	1
	Provisions for litigation	2	1	2	1	1	1	1
	Other provisions	1	1	1	1	1	1	1
<b>Subtotal for Hotels and Restaurants</b>		<b>3</b>	<b>2</b>	<b>4</b>	<b>3</b>	<b>3</b>	<b>3</b>	<b>3</b>
Transport and Storage	Provisions for mandate contract	0	0	0	1	1	1	1
	Provisions for guarantees to customers	1	1	1	0	0	0	0
	Provisions for litigation	2	2	2	2	2	2	1
	Provisions for profit sharing payable to employees	0	0	1	1	1	1	1
	Other provisions	2	2	2	2	2	2	2
<b>Subtotal for Transport and Storage</b>		<b>5</b>	<b>5</b>	<b>6</b>	<b>6</b>	<b>6</b>	<b>6</b>	<b>5</b>
<b>TOTAL</b>		<b>27</b>	<b>27</b>	<b>32</b>	<b>30</b>	<b>30</b>	<b>29</b>	<b>25</b>

*Source: authors' projection based on the financial statements of the analysed companies*

The surveyed companies continue to recognize provisions for risks related to business operations in all of the 7 analysed years (Table 2), therefore they show a prudent position, even though the notion of prudence was eliminated from the Conceptual Framework in 2010. So, if the entities had doubts about the value of the liabilities they exercised caution and their judgement did not change.

Different types of provisions were recognised by companies operating in different industries, supporting our assumption that there is a link between provisions, as a proxy for prudence, and business risks. Thus, in the case of the extractive industry, the core business of the companies generates the risk that a future outflow is required in order to settle the obligation to dismantle and relocate assets as well as the obligation regarding land restoration; accordingly, for these entities, the most prevalent type of provision is

represented by the provision for the decommissioning and restructuring costs. In the constructions industry, provisions for guarantees to customers are the most frequent since the highest risk incurred by entities in this field is that goods may not be delivered in the terms and conditions provided by contracts. In the case of hotels and restaurants, the operational risk could consist of complaints from customers and other interested parties and costs incurred by a lawsuit. Accordingly, the presence of the provisions for litigation in most of the surveyed financial reports is appropriate for addressing this risk.

So, removing the word 'prudence' from Conceptual Framework did not mean an imprudent behaviour in accounting reporting.

In order to achieve the main objective of our research, our second focus was on marking out the presence of impairment/write-down of assets in the financial statements of the analysed entities.

The impairment/write-down recognised in each industry and the frequency of companies that report these elements is presented in the table below:

*Table 3. Types and frequency of assets' impairment and write-down during 2010-2016 by industry*

Industry	Type of provision	Frequency (number of entities)						
		2010	2011	2012	2013	2014	2015	2016
Extractive Industry	Impairment of intangible assets	1	2	2	2	2	2	2
	Impairment of tangible assets	1	2	3	3	3	3	3
	Impairment of financial assets	0	1	2	1	2	1	1
	Impairment of long term loans	1	1	1	1	3	2	0
	Write-down of inventories	2	2	2	2	2	2	2
	Allowances for doubtful customers	3	3	3	3	3	3	3
	Allowances for other doubtful debts	3	3	3	2	2	2	2
	Impairment of short-term financial investments	0	0	0	0	1	1	0
<b>Subtotal for the Extractive industry</b>		<b>11</b>	<b>14</b>	<b>16</b>	<b>14</b>	<b>18</b>	<b>16</b>	<b>13</b>

Manufacturing Industry	Impairment of tangible assets	0	0	3	3	3	2	2
	Impairment of financial assets	1	1	1	1	0	0	0
	Write-down of inventories	3	3	3	2	3	2	2
	Allowances for doubtful customers	3	3	3	3	3	3	3
	Allowances for other doubtful debts	1	1	1	1	1	1	1
<b>Subtotal for the Manufacturing industry</b>		<b>8</b>	<b>8</b>	<b>11</b>	<b>10</b>	<b>10</b>	<b>8</b>	<b>8</b>
Constructions	Impairment of tangible assets	0	0	1	1	1	1	1
	Impairment of investment property	0	0	1	1	1	1	1
	Impairment of financial assets	1	1	2	2	2	2	2
	Write-down of inventories	1	1	1	0	0	0	0
	Allowances for doubtful customers	2	3	3	3	3	3	3
	Allowances for other doubtful debts	1	1	1	1	1	1	1
<b>Subtotal for Constructions</b>		<b>5</b>	<b>6</b>	<b>9</b>	<b>8</b>	<b>8</b>	<b>8</b>	<b>8</b>
Hotels and Restaurants	Impairment of tangible assets	0	0	0	1	0	0	1
	Impairment of financial assets	0	1	1	1	1	1	0
	Write-down of inventories	0	0	1	1	1	1	1
	Allowances for doubtful customers	1	1	2	2	2	2	2
	Allowances for other doubtful debts	1	1	1	1	1	1	1

<b>Subtotal for Hotels and Restaurants</b>		<b>2</b>	<b>3</b>	<b>5</b>	<b>6</b>	<b>5</b>	<b>5</b>	<b>5</b>
Transport and Storage	Impairment of intangible assets	0	0	0	1	1	1	1
	Impairment of financial assets	1	1	1	1	1	1	2
	Write-down of inventories	2	2	2	2	2	2	2
	Allowances for doubtful customers	2	2	2	2	2	2	2
	Allowances for other doubtful debts	2	2	2	2	2	2	2
<b>Subtotal for Transport and Storage</b>		<b>7</b>	<b>7</b>	<b>7</b>	<b>8</b>	<b>8</b>	<b>8</b>	<b>9</b>
<b>TOTAL</b>		<b>33</b>	<b>38</b>	<b>48</b>	<b>46</b>	<b>49</b>	<b>45</b>	<b>43</b>

*Source: authors' projection based on the financial statements of the analysed companies*

Overall, during the 7 analysed years, the impairment of assets and write-down of assets show a general ascendant tendency, reflecting an increase in the frequency of companies that cautiously report the carrying amount of assets. An important increase can be noticed in 2012 (the year of the first-time adoption of IFRS by Romanian listed entities). Different types of impairment/write-down of assets were recognised by companies operating in different industries, supporting our assumption that there is a link between these elements, as a proxy for prudence, and the faithful representation of accounting information (Table 3).

### **Conclusions**

Obviously, recognizing provisions and impairment/write-down of assets requires the use of estimates in Accounting. Thus, the value of these elements influences the performance of the company. It is hard to analyze if the estimates made led to the 'smoothing of profits' even in the absence of the concept of prudence in the Conceptual Framework. Certainly, the recourse to prudence can lead to an exaggeration in the way estimates are made, but ultimately professional judgment is the one that must prevail in any situation. Prudence or neutrality in Accounting does not justify a professional judgment that does not circumscribe the faithful representation of accounting information.

The elimination of the prudence concept from the Conceptual Framework did not change the professional judgements in accounting reporting. Studying the provisions and impairment/write-down of assets for the financial reporting over a period of 7 years (2010-2016) for 13 companies listed on BSE, in the context of the risks affecting the surveyed companies, shows constancy of the accounting judgments. It was not prudence the basis for the provisioning and adjustment for impairment, but the need to ensure the

neutrality of accounting information and the obligation to comply with IFRS. Therefore, from our point of view IFRS contributes to prudence.

The existence of the same risks has led to the recording of the same types of provisions and impairment of assets in the financial reporting of the analyzed companies, which means that there is no need for a link between prudence and the prudent judgments in accounting. Thus, prudence will never have been deleted for preparers.

Our findings indicate that the elimination of prudence did not affect the way and method of presentation of the provisions and of the impairment/write-down of assets in the financial statements of listed companies in Romania. The business risks mentioned in the Notes have led to the recognition of provisions in the entities accounting and the impairment/write-down of assets. A faithful representation, relevance, and neutrality in professional judgment contribute to the cautious way of presenting the accounting information over the period under review.

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