CFA Society United Kingdom

2nd July 2013

EFRAG
35 Square de Meeûs
B-1000 Brussels
Belgium

Dear EFRAG,

The Financial Reporting and Analysis Committee (FRAC) of the Chartered Financial Analyst Society of the UK (CFA UK) would like to respond to the paper issued by the European Financial Advisory Group (EFRAG) called 'Getting a Better Framework: Prudence Bulletin'.

CFA UK represents more than 10,000 investment professionals working across the financial sector. For advocacy purposes in the field of financial reporting, these members are represented by the Financial Reporting and Analysis Committee.

Introduction

The UK Shareholders Association and others that have attacked IFRS on the basis that "prudence is missing" seem to think that there was a golden age, under UK GAAP, when company accounts never misled investors. This idea is countered by the fact that there were plenty of corporate scandals before the EU's implementation of IFRS in 2005.

The difficulty of predicting a business's success based on limited – and sometimes deceptive – financial information is as old as business itself. Accounting standards were brought in both to give investors more information and to counter abuse, such as "big bath" provisions on acquisitions. The standards remain a work in progress, with the switch from an incurred loss to an expected loss model for loan losses as one example. Whatever the standards, good financial analysis relies on investors – individuals as well as institutions – using the information well.

The 10,000-plus members of CFA Society of the UK are focused on making the best use of all the information that is provided by and about companies and their markets. Accounting standards are an important part of that and we support the move towards a set of high-quality global standards, which the IASB continues to lead. Any reversion to UK GAAP, or an EU GAAP, would be a retrograde step.

Prudence

IFRS may not use the word 'prudence' but other requirements should ensure that the numbers are accurate (or best estimates) and useful to investors. The main ones are: relevance and faithful representation backed up by such characteristics as free from error, neutrality (free from bias) and verifiability. The definition of materiality states that information must be included if omitting or mis-stating it could influence users' decisions. So, the principles are clear.

At first sight, for British constituents, it may seem that prudence is a good thing in measurement, implying carefulness and sound judgment. But, as the FRC and other EU standard-setters have pointed out, there is a question over what prudence means.

When taken to mean conservatism, it builds in a negative bias. The problems with this are, first, that if a number is to be reduced because of prudence, then by how much? It multiplies the subjective element in what should be a best estimate. Second, management has used the leeway allowed by a conservative bias to smooth earnings by understating profits in good years and feeding back provisions in bad ones. This does not reflect the underlying economic reality. Third, in buying and selling securities, a conservative bias allows the vendor to over-state gains, and would the buyer need to make an immediate write-down implying it had over-paid?

Accounting standards are, in any case, not the only backstop. Company law requires that the accounts present a true and fair view. For the reasons stated above, we believe there is no contradiction between a true and fair view and neutrality in measurement; it would be more difficult to reconcile bias with it. Prudential regulation covers the capital, liquidity and risk-taking of financial institutions.

Together, accounting standards, company law and other regulation give auditors ample guidance in performing their essential role. It is simply not true to say that they have "no argument to stand on when they question a valuation". It is their job to challenge valuations that are inaccurate or inappropriate. If they do not do this under the current regime, then how can they be trusted to do so under one that would embed much more subjectivity?

Failure to resist management attempts to present a biased, incorrect or misleading (effectively an imprudent) view of the numbers, would also indicate a governance weakness within the audit committee and the board. The role of ensuring proper and consistent application of the standards is a matter for national and EU supervisors.

The conceptual framework and the standards
We do not believe there is any contradiction between the framework and the standards, which are obviously more specific. The over-ride in IAS 1 stresses the consistently stated point that the information must be useful to users. Valuations that are as accurate as possible – that is, free from bias and error – are more useful than ones that are over- or under-stated.

There are, of course, limitations to accounting standards, to which the framework refers. Financial reports do not provide all the information that investors need. Numbers are often based on estimates, judgments and models. This means there is inherent scope for professional judgment, which should be applied rigorously in the interests of investors.

To help us assess professional judgments, the framework points to the need for a company to provide information about underlying assumptions and methods. This principle is followed through in IAS 1 and other standards. So, investors should be able to see the sensitivity of certain judgments and realise that there is a range of potential answers. This is why the notes to the accounts are particularly helpful.

Investors must also be aware that numbers reported for the balance sheet date are just that: they are bound to change. Both financial professionals and individual investors should be able to recognise when an important valuation is both sensitive to particular assumptions and inherently volatile. The valuation of a quoted dotcom company on December 31 1999, for instance, was its closing price on that date. But only an imprudent investor would have concluded that it was unlikely to fall.

Conclusion
We do not think that accounting standards can, or should, be used as a substitute for sound business management or prudential regulation. They are simply the starting point for financial analysis by users of accounts, including individual shareholders. IFRS is not perfect, but it is the best set of standards on offer for publicly listed companies operating in international capital markets.

Rigorous application of the standards depends on diligent auditing in the interests of investors, and enforcement by company and market supervisors. For our part, as investors and their agents, we accept responsibility to make the best use of all the financial information made available to us.

Those calling for change, and for the institution of a regime based on "prudence", need to be clear about what they mean. They should explain how financial reporting would be different and why they think this would provide investors and other users of accounts with a better set of information.

We refute the assertion made by the UK Shareholders Association that "Prudence was the ultimate protection for investors". Investors have many protections, among them audited information provided in IFRS accounts. It is the investors' job to use that information wisely – prudently even – in making capital allocation decisions and in holding management to account.

We look forward to discussing the issues raised in this response.

Yours sincerely,

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About CFA UK and CFA Institute

The CFA Society of the UK (CFA UK) represents the interests of more than 10,000 leading members of the UK investment profession. The society, which was founded in 1955, is one of the largest member societies of CFA Institute and is committed to leading the development of the investment profession through the promotion of the highest ethical standards and through the provision of continuing education, advocacy, information and career support on behalf of its members. Most CFA UK members have earned the Chartered Financial Analyst® (CFA®) designation, or are candidates registered in CFA Institute's CFA Program. Both members and candidates attest to adhere to CFA Institute's Code of Ethics and Standards of Professional Conduct.

CFA Institute is the global association for investment professionals. It administers the CFA and CIPM curriculum and exam programs worldwide; publishes research; conducts professional development programs; and sets voluntary, ethics-based professional and performance-reporting standards for the investment industry. CFA Institute has more than 100,000 members in 140 countries, of which more than 90,000 hold the Chartered Financial Analyst (CFA) designation.