a) If financial information is to be useful, it must be relevant and faithfully represent what it purports to represent’ (IFRS, 2018). Financial information must exhibit the fundamental qualitative characteristics of relevance and faithful representation to be valuable and assist users in making decisions regarding the provision of resources to an entity (IFRS, 2018). Comparability, verifiability, timeliness and understandability improve the usefulness of financial information (IFRS, 2018). Information is relevant when it is able to make a difference in the users’ decisions, and has predictive and/or confirmatory value (IFRS, 2018). The predictive value criterion ensures that financial information can be employed by users to form useful expectations about the future. Information has confirmatory value, providing that it allows users to reaffirm or adjust prior expectations. Materiality is an entity-specific relevance aspect which refers to the impact of an omission or misstatement of financial information on the economic decisions and actions of users (IFRS, 2018). Thus, the relevance of the information presented in financial reports is determined by how accurately it reflects the past events and aids in anticipating future outcomes.

For accounting information to possess a representational faithfulness it is necessary to account for transactions and events according to their substance and economic reality (IFRS, 2018). The substance of the phenomenon must faithfully represent the true and fair view of business transactions, not only their legal aspects (IFRS, 2018). To be perfectly faithfully depicted, the financial information must have the underlying characteristics of completeness, neutrality and freedom from error (IFRS, 2018). All of the information that a reader of the financial statements needs to understand the nature of phenomena being described should be complete and entail necessary explanations along with numerical representations (IFRS, 2018). Although there should be no errors or omissions in the reported information, it cannot be perfectly accurate as in the process of estimation, it might be complex to determine the accuracy or inaccuracy of some values. A depiction of the information in the financial statements must be neutral and free from bias to reflect a balanced view of the state of the company without attempting to misguide users or present a business in a more favourable light. Neutral information is able to make a difference in users’ decisions and it must be free from deliberate or systematic bias (IFRS, 2018). It is not always possible to explicitly determine an amount at which an item must be disclosed in the financial statements, hence the monetary amounts need to be estimated with involvement of professional judgment (IFRS, 2018). The measurement uncertainty induces accountants to use fair estimations in the preparation of financial reports cautiously, provide all important descriptions and clear explanations so that not to undermine the usefulness of financial information.

To increase the trustworthiness of the figures reported in companies’ financial statements and make those estimates be shown from a realistic perspective, the concept of prudence was introduced. It should be applied when there are estimates to be produced under conditions of uncertainty (IFRS, 2018). Prudence assures that the entity’s income and assets are not overstated, whereas its expenses and liabilities are not understated (Elliot and Elliot, 2017). Under this principle, accountants are required to record expenses and liabilities as soon as they occur, but revenues are recognised by the company when they are realised (Elliot and Elliot, 2017). ‘Neutrality is supported by the exercise of prudence’ (IFRS, 2018). Prudence assumes that a business should take into account the potential risks and losses related to its assets and liabilities, and portray a realistic view of the affairs of the company. It prevents reporting entities from being overly optimistic in their forecasts and estimates, meaning that they avoid the overstatement (understatement) of assets (liabilities) when there is uncertainty in presence (IFRS, 2018). Prudence is inherently embedded in the standards and is used by preparers of financial accounts in the process of application of those standards (ACCA, 2014). An example of exercising prudence is: a company revalues its assets periodically and records an impairment when the asset’s carrying amount exceeds the benefits expected to be gained from that asset.

b) IAS 36 ‘Impairment of Assets’ considers all tangible and intangible assets except for those, that are covered by other standards. It ‘prescribes the procedures that an entity applies to ensure that its assets are carried at no more than their recoverable amount’ (IAS 36, 2018). The objective of IAS 36 is to make sure that if an asset’s carrying amount exceeds the amount that could be recovered through current use or selling the asset, a company must recognise an impairment loss (IAS 36, 2018). According to IAS 36, an impairment test must be performed annually for goodwill obtained in a business combination and intangible assets with an indefinite useful life or those, that are not yet ready for use, irrespective of whether there is an indication of impairment (IAS 36, 2018).

At the end of the reporting period, a company must assess whether an asset may be impaired by referring to external and internal sources of information (IAS 36, 2018). The external indications of impairment can be spotted when: an asset’s market value declines, adverse changes take place in the environment where an entity operates, interest rates go up or company’s net assets’ carrying amount is greater than its market capitalisation (IAS 36, 2018). The internal factors to be considered are: evident physical damage or obsolescence of an asset, an asset has become idle or part of a restructuring and is planned to be disposed of, evidence from internal reporting that an asset’s economic performance will be lower than expected (IAS 36, 2018). Further, if an internal or external indicator of impairment is detected, the asset’s recoverable amount must be formally estimated; the asset’s useful life, depreciation (amortisation) method or the residual value are required to be reviewed and adjusted (IAS 36, 2018). The standard requires an entity to make a provision for an impairment loss so that a reduction in fair value of the assets is reflected on a company’s balance sheet and the true value of the assets is represented (IAS 36, 2018).

IAS 36 defines recoverable amount as ‘the higher of an asset’s or cash-generating units’ fair value less costs to sell and its value in use’ (IAS 36, 2018). Fair value less costs to sell is the arm’s length sale price of an asset or cash-generating unit between well-informed willing parties less disposal costs (IAS 36, 2018). The value in use is the expected future cash flows obtainable from an asset or cash-generating unit discounted to present value (IAS 36, 2018). When the carrying amount is less than the recoverable amount there is no impairment loss to recognise, otherwise, if either the fair value less costs of disposal or the value in use is greater than the carrying amount, an impairment occurs (IAS 36, 2018). An entity shall recognise an impairment loss in the statement of profit or loss when the asset is accounted for under the relevant cost model (IAS 36, 2018). However, if the asset is treated according to the revaluation model, the impairment loss is recorded as a revaluation decrease in comprehensive income, but it should not go beyond the amount of revaluation surplus for that particular asset (IAS 36, 2018). Subsequent depreciation (amortisation) is based on the revised carrying amount and must be adjusted in future periods (IAS 36, 2018).

c) Sometimes businesses need to produce estimates of accounting transactions and other events under conditions of uncertainty, where cautious and prudent judgments should be made to present conservatively-stated financial statements. The rationale behind prudence is that an entity should not overstate its net assets: it is not allowed to report an asset at a value which is higher than the amount to be recovered from its use or sale (IFRS, IAS 36, 2018). When a company conducts an asset impairment, it shows that the market value of the acquired assets has declined below the amount the company originally purchased them at, hence the ‘updated’ asset value is disclosed (IAS 36, 2018). The impairment procedure takes place to ensure the true value of an asset is provided in the financial statements so that companies cannot benefit from better-reported profitability and usage of creative accounting techniques (Elliot and Elliot 2017). Excessively optimistic or imprudent estimations made by managers are counteracted by the application of precautionary principle and reflecting conservative estimates of a company’s assets, liabilities, income and equity (Barker and McGeachin, 2015).

However, prudence may embody asymmetric requirements: some standards sacrifice the competing symmetric approach to prudence with the view to selecting the most relevant and faithfully represented financial information (IFRS, 2018). Under this approach, a business should delay the recognition of gains if there is measurement uncertainty, which means that impairment losses are more likely to be recognised than an increase in the economic value of an asset (Barker and McGeachin, 2015). Because assets are typically recognised at their historical costs, the standard usually recognises a decline in asset value as an impairment (ACCA, 2014). However, an increase in asset value cannot be recognised until the date of sale of the relevant asset (ACCA, 2014). Understating assets or overstating liabilities in one accounting period results in the overstatement of financial performance in the following periods, which is a consequence of a conservative bias in financial reporting (ACCA, 2014). It is also noted, that an understatement of assets may be a manifestation of earnings manipulation: inflating profits in subsequent periods through excessive asset impairments in the current accounting period (Barker and McGeachin, 2015). Intentional under- or over-statement of financial position and performance is misguiding and leads investors to make erroneous decisions on the allocation of capital (Barker and McGeachin, 2015). Despite the introduction of non-asymmetrically inclined prudence, there is still a tendency to understate net assets due to the goal of compliance to relevant and faithfully represented financial information (IFRS, 2018).

Another accounting treatment under IAS 36 that shows inconsistency with prudence is measuring assets at fair value or using models based on future cash flows (ACCA, 2014). For instance, to measure impairment of an asset or cash-generating unit the recoverable amount must be calculated. It comprises of the value in use which is determined for impairment purposes by taking into account the company’s cash flow projections, that are based on management’s assumptions and estimates (IAS 36, 2018). IAS 36 enacts that ‘the value in use should be calculated using estimates of future cash inflows for an asset or cash-generating unit in its current condition’ over its remaining useful life (IAS 36, 2018). This valuation technique is focused on the asset’s present condition only and does not consider management plans for restructuring the asset or enhancing its potential capacity (IAS 36, 2018).

To conclude, IAS 36 – Impairment of Assets does follow an admonition of prudence and is consistent with its underlying principles, but is not a perfect example of the implementation of prudence. IAS 36 requires that businesses should review their assets regularly to check for a decline in their values, which shows compliance and alignment with prudence. Nonetheless, in the process of impairment under IAS 36 biased and imprudent calculations might be obtained due to uncertainty in measurement. From my perspective, prudence will always remain a controversial area of swirling debates, as subjective judgments and estimates cannot be fully obviated from the financial reporting. The solution lies in companies’ ability to be transparent in accounting methods they select, provide explanations and reasonably justify the subjacent assumptions.

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