Demystifying Accounting Conservatism

Existence of conservatism in accounting can be dated back to centuries (Basu, 1997; Watts, 2003) and is discussed in financial accounting course and also practiced by accountants in financial reporting. Recently there has been a debate that whether conservatism goes against another principle of accounting i.e. neutrality. As per the viewpoints given on the Conceptual Framework for financial reporting FASB, conservatism introduces an unacceptable degree of bias in accounting information. Research has been conducted in developed economies regarding how it impacts various users of accounting information and also regarding what are the types, basis and measures of conservatism. Read on to know more.....

I. Introduction: Conservatism is one of the fundamental characteristics of financial accounting. Traditionally Accounting Conservatism is defined by the Adage "anticipate no profit, but anticipate all losses" (Bliss 1924[1]). Conservatism is accountants' tendency to require a higher degree of verification for recognising good news than bad news in financial statements (Basu 1997[2]). As per Accounting Standard 1 of ICAI, "the primary consideration in the selection of accounting policies by an enterprise is that the financial statements prepared and presented on the basis of such accounting policies should represent a true and fair view of the state of affairs of the enterprise as at the balance sheet date and of the profit". To represent true and fair view, many

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[1] Bliss, J. H. 1924. Management through accounts. New York: The Ronald Press Co.
[2] Basu, S. (1997). The conservatism principle and the asymmetric timeliness of earnings. *Journal of Accounting and Economics*, 24, PP 3–37.

accounting principles are considered of which one is conservatism/prudence. As per AS (1), " In view of the uncertainty attached to future events, profits are not anticipated but recognised only when realised though not necessarily in cash. Provision is made for all known liabilities and losses even though the amount cannot be determined with certainty." The accounting standards clearly favour conservatism by adopting lower of the cost and net realisable value for inventories and impairment testing for assets.

Existence of conservatism in accounting can be dated back to centuries (Basu, 1997[3]; Watts, 2003[4]), the question is, is it beneficial/costly for financial reporting. Recently, there has been debate on the role of conservatism in financial reporting. As per the viewpoints given on the Conceptual Framework for financial reporting FASB, conservatism introduces an unacceptable degree of bias in accounting information. The FASB does not include conservatism as a qualitative aspect of faithful representation because including it would be inconsistent with neutrality. Some stakeholders disagree with this view as they believe 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 (FASB 2010).

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. Another view is that neutrality is impossible to achieve, as 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. (FASB 2010)

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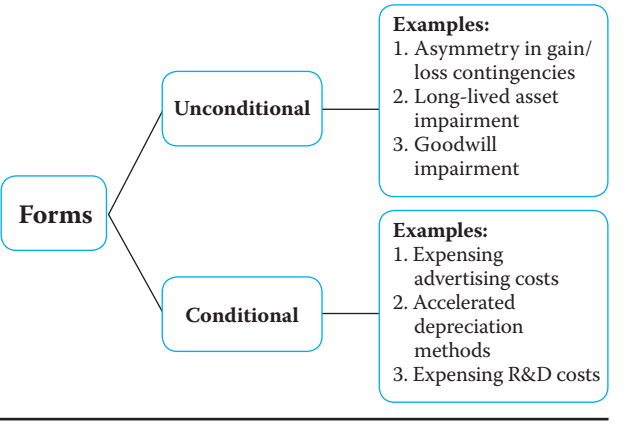
As per valuation perspective, accounting should provide for information to assess the intrinsic value of equity and help arrive at investment decisions. As per contracting perspective, the role of accounting is to provide information that allows contracting parties to evaluate efficiency and effectiveness with which obligations are performed (Ruch and Taylor 2015).

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 lack of neutrality. This debate arises primarily because of two different perspectives assigned to accounting, i.e., valuation perspective and contracting perspective. As per valuation perspective, accounting should provide for information to assess the intrinsic value of equity and help arrive at investment decisions. As per contracting perspective, the role of accounting is to provide information that allows contracting parties to evaluate efficiency and effectiveness with which obligations are performed (Ruch and Taylor 2015[5]).

Conservatism can be classified into two broad forms i.e., unconditional and conditional (Ball and Shivakumar 2005[6])



[3] ibid
[4] Watts, R. (2003): Conservatism in Accounting Part I & II (Explanations and Implications; and Evidence and Research Opportunities) *Accounting Horizons*, 17, PP 207–221 (September), PP 287-301 (December).
[5] Ruch, George W and Taylor Gary (2015), Accounting Conservatism: A review of the literature. *Journal of Accounting literature* Volume 34, February 2015, Pages 17–38
[6] Ball, R., & Shivakumar, L. (2005). Earnings quality in UK private firms: Comparative loss recognition timeliness. *Journal of Accounting and Economics*, 39, PP 83-128.

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II. Forms of Conservatism:

a) **Unconditional Conservatism** is defined as an accounting bias towards reporting low book values of net assets relative to their market value, and it is done without any regard to any event. Thus, unconditional conservatism will have relatively consistent impact on profit and loss statement, as it is a systematic reduction in an accounting number; and the net assets shall be understated in balance sheet. As per study by Qiang 2007[7], organisations resort to unconditional conservatism to avoid taxes, litigation risk and accounting regulations. For e.g., adopting accelerated depreciation methods, expensing research & development costs and expensing advertising costs.

b) **Conditional Conservatism** (ex post or news dependent conservatism) occurs when negative economic news is recognised in accounting earnings in timelier manner than the positive economic news (Ruch and Taylor 2015[8]). This results in asymmetric recognition of the positive and negative news; it is defined as asymmetric timelines (Basu 1997[9]) or asymmetric verification (Watts 2003[10]) conditional on an event. Conditional conservatism exists when economic losses are recognised in the income statement faster than economic gains. For e.g., Goodwill impairment and long lived asset impairment and asymmetric treatment of loss or gain due to contingencies (Vishnani and Bhatia 2017[11]).

Going by the research in the area of conservatism, conditional conservatism is more prevalent than unconditional conservatism; it may be because that it communicates information regarding unexpected events. As per research, the conditions for these types of conservatism are also different, conditional conservatism happens in settings where contracting and litigation costs are high and unconditional conservatism happens where litigation, regulatory and tax costs are high (Qiang 2007[12]). Research also suggests that application of one type of conservatism affects the application of other type of conservatism. Beaver and Ryan (2005)[13] observed that unconditional conservatism creates accounting slack and that prevent the application of conditional conservatism.

Watts (2003[14]) provides the following four potential explanations for the existence of conservatism in accounting.

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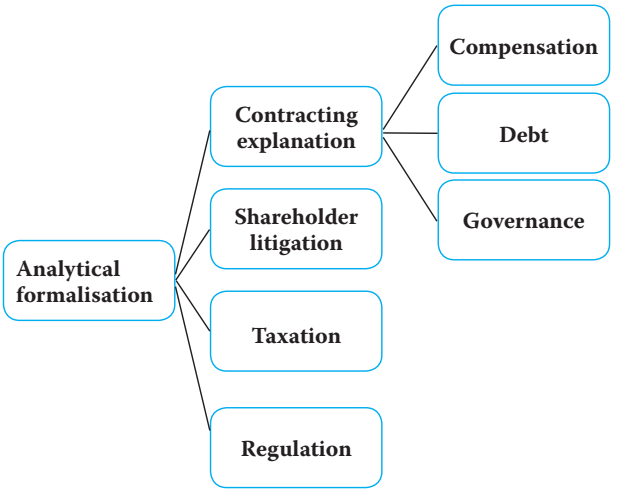

[7] Qiang Xinrong (2007) The Effects of Contracting, Litigation, Regulation, and Tax Costs on Conditional and Unconditional Conservatism: Cross-Sectional Evidence at the Firm Level. *The Accounting Review*: May 2007, Vol. 82, No. 3, pp. 759-796.
[8] Ruch, George W and Taylor Gary (2015)
[9] Basu, S. (1997)
[10] Watts, R. (2003)
[11] Vishnani and Bhatia (2017) Accounting Conservatism and Corporate Governance: Evidence from Indian Banking Sector, presented at International Conference on Financial Markets & Corporate Finance at IIT Kharagpur, 7th- 8th July 2017.
[12] Qiang Xinrong (2007)
[13] Beaver, W., & Ryan, S. (2005). Conditional and Unconditional Conservatism: Concepts and Modeling. Review of Accounting Studies, 10, PP 269–309
[14] Watts, R. (2003)

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III. Analytical Formalisation:

a.) **Contracting explanation:** Firms incur high agency costs as agents (managers) are driven by self interest (Jensen and Meckling, 1976[15]), to reduce agency costs equity shareholders contract with managers through financial accounting. Watts 2003[16] described contracting explanation into three distinctive categories i.e. Compensation, Debt and Governance theories:-

i) **Contracting compensation theory:** This theory deals with managers' opportunistic behaviour, they are driven by their own compensation which is mostly linked with the profitability of the firm. They therefore, tend to have shorter horizon than shareholders as their compensation is linked with firm performance through compensation contracts (Blunck 2013[17]). Managers are willing to sacrifice firm's long term value for its current performance (Graham et al.2005[18]) as earnings are key driver for managerial compensation (Sloan 1993[19]). To counteract this tendency some shareholders demand conservative accounting (Blunck 2013[20]). Conservatism offsets this bias by deferring earnings and understating cumulative earnings and net assets. The bad news is reflected on timelier basis and managers are more likely to be held responsible for wrong decisions and good news is not reported unless it is more likely to be realised.

ii) **Contracting debt theory:** Accounting conservatism has been considered as a reporting mechanism that increases debt contracting efficiency. As per this theory, the debt holders demand conservatism in accounting as information about borrower losses is more relevant to debt holders than information about borrower gains. This is because the upside is capped. In debt contracting, timely loss recognition affects the effectiveness of financial covenants, which are used to define the property and decision rights between debt holders and shareholders. Once borrower's financial condition deteriorates, timely loss recognition triggers covenant violations more quickly. Therefore, debt holders are able to obtain the control rights in a timely manner and take necessary actions to protect their interests. (Zhang 2008[21])

iii) **Contracting governance theory:** Governance deals with ways in which suppliers of finance to corporations assure themselves of getting return on their investment (Shleifer and Vishny 1997[22]). As per governance theory through symmetric timeliness of earnings shareholders monitor managers more effectively. Few studies (Ahmed and Duellman 2007[23]; Qiang 2007[24]) found association between corporate governance and accounting conservatism, as per these studies firms with higher quality governance mechanism impose accounting conservatism on managers.

Conservatism in accounting is achieved through timeliness, verifiability and asymmetric verifiability (Watts 2003[25]). When earnings are reported the timeliness of recognising economic losses exceeds that of economic profits, resulting in asymmetric timeliness for recognition. Much information that could make earnings and net assets timely and informative cannot be easily verified (Watts 2003[26]). Most of this information is future-oriented and is based on certain assumptions; for example, positive net cash

[15] Jensen, M. C., & Meckling, W. H. (1976). Theory of the firm: Managerial behaviour, agency costs and ownership structure. *Journal of Financial Economics*, 3(4), 305-360.
[16] Watts, R. (2003)
[17] Blunck (2013) Evidence on the contracting explanation of conservatism, *Journal of Finance & Accountancy*; 2013, Vol. 13, p1
[18] Graham John R., Harvey Campbell and Rajagopal Shiva (2005) The economic implications of corporate financial reporting. *Journal of Accounting and Economics*, 2005, vol. 40, issue 1-3, pages 3-73
[19] Sloan Richard G. (1993) Accounting earnings and top executive compensation *Journal of Accounting and Economics*, 1993, vol. 16, issue 1-3, pages 55-100
[20] Blunck (2013)
[21] Zhang, J., 2008. The contracting benefits of accounting conservatism to lenders and borrowers. *Journal of Accounting and Economics* 45, 27-54.
[22] Shleifer, A., & Vishny, R. W. (1997). A survey of corporate governance. *Journal of Finance*, 52, 737–783.
[23] Ahmed, A. S., & Duellman, S. (2007). Accounting conservatism and board of directors characteristics: An empirical analysis. *Journal of Accounting and Economics*, 46(2/3), 411-437.
[24] Qiang Xinrong (2007)
[25] Watts, R. (2003)
[26] ibid

flows arising from investment decision by a manager; as these projections cannot be verified, these are therefore, not included in the contracts. The contracting parties have their own objectives regarding asymmetric verifiability; for example, lender wouldn't gain in case net assets are above the value of the loan but if the net assets value goes down than the value of the loan, the lenders will be at loss; therefore through covenants in debt agreements, they ensure conservatism in accounting. As per Watts 2003[27], "In the incentive compensation case, without verifiable earnings measures the manager receives overpayments that leave shareholders with a lower share value, even after adjusting for the value added by the manager, and the shareholders are unable to recover the overpayment because of the manager's liability."

b.) **Shareholder litigation:** Conservatism is seen as an efficient response to agency problems arising from information and it reduces expected shareholder litigation costs (Watts, 2003[28]; LaFond & Watts, 2008[29]). By overstating firm's net assets, there's high probability of generating litigation costs *vis-à-vis* by understating net assets. As the expected litigation costs of overstatement are more than that of understatement, firm's management have motivation to report conservative values for net assets and earnings. This explanation applies more to developed markets than to other markets.

c.) **Taxation:** As per the taxation explanation firms show fewer profits to lower their tax expenses and they use accounting conservatism to do that. By delaying the recognition of revenue/gains and by timely recognition of expenses/losses they defer the tax payments.

d.) **Regulation:** Standard setters and regulators are more likely to face more criticism if earnings and net assets are overstated than if they are understated, therefore they favour conservatism in accounting.

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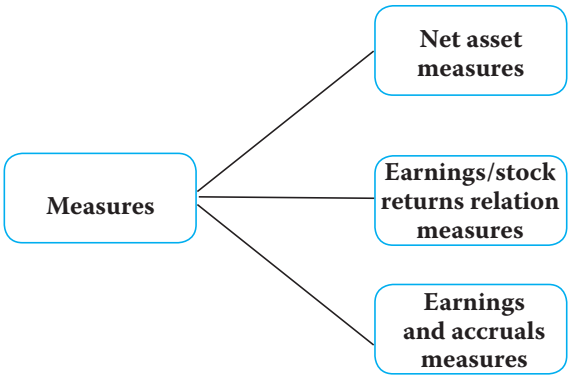

IV. Measuring Conservatism:

i. **Net asset measures:** As per conservatism principle if there is an increase in the value of an asset (or decrease in the value of liability), which cannot be sufficiently verifiable, it will not be recorded whilst decrease in the value of an asset (or increase in the value of liability) with similar level of verifiability will be recorded. As a result of this, the net assets are understated; researchers

[27] ibid
[28] ibid
[29] LaFond, R., Watts, R., 2008. The information role of conservatism. *The Accounting Review* 83, 447-478.

have used the ratio book to market value to assess conservatism. Beaver and Ryan (2000)[30] determined conservatism with this measure, the firms which are conservative in accounting shall report lower net assets and lower book to market ratios.

ii. **Earnings and accruals measures:** Losses of the same degree of verifiability are recognised timely, this results in drop in earnings whereas the gains shall not be recognised at the time at which it occurs but over later periods when they are realised; this implies that the gains shall be more persistent than the losses. The losses/ earnings decreases shall not recur in future periods whereas positive earnings shall persist; this provides a measure of conservatism. As per Basu (1997[31]) and Watts (2003[32]), negative earnings change are more likely to reverse in the coming period than the positive earnings changes.

As per conservatism, losses will be totally accrued whereas gains are not, this results in asymmetry in accruals; this provides us with another measure of conservatism i.e. negative periodic net accruals and negative cumulative accumulated accruals. Givoly and Hayn (2000[33]) suggested the sign and magnitude of accruals over a period of time as a measure of conservatism.

iii. **Earnings/stock returns relation measures:** As per efficient market hypothesis, the stock market absorbs the change in asset value as and when it occurs. Through conservatism the losses are reflected on timely basis as compared to gains, thus the losses are more contemporaneous with stock returns than with accounting gains. This can be measured by a larger response coefficient for negative return than for positive return in an earnings-return regression.

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V. Conclusion: Conservatism as an accounting principle does impact financial reporting and as a result impacts financial statement users in equity and debt markets. The objective/s of users is distinct, shareholder prefer information from valuation perspective whereas debt holder prefer information from contracting perspective. Research reveals that conservatism reduces analyst forecast accuracy and it also brings down the cost of debt. Internationally, research has been conducted in the area of conservatism from financial statement users perspective (equity shareholders & debt holders), corporate governance perspective, value relevance perspective, contracting perspective, earnings quality perspective, analyst forecast perspective and disclosures perspective. There's been limited number of studies based in India, Vishnani & Misra (2016[34]) established that conditional accounting conservatism exists in India and as per the findings of Chopra (2015[35]) accounting conservatism in India has increased over time; other aspects of conservatism are still unexplored. ■

[30] Beaver, W., & Ryan, S. (2005).
[31] Basu, S. (1997).
[32] Watts, R. (2003)
[33] Givoly, D., Hayn, C., 2000. The changing time-series properties of earnings, cash flows and accruals: Has financial accounting become more conservative? *Journal of Accounting and Economics* 29, 287-320.
[34] Vishnani, S. and Misra, D. (2016); Accounting Conservatism: Evidence from Indian Markets. Theoretical Economics Letters, 6, 1000-1016. http://dx.doi.org/10.4236/tel.2016.65100
[35] Chopra Seema (2015) Conservatism in Accounting: An Empirical Study of Indian Companies. *International Journal of Financial Management*, Vol 5, No 3 (2015) page 30-45