

Accounting Conservatism: A Review of Literature

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Abstract. Conservatism is one of the most controversial principles in financial reporting giving the conflicting perspectives of users of financial information on its effect. This study therefore reviews the conceptualization, operationalization, and empirical findings on accounting conservatism. We conclude that accounting conservatism cannot be totally eliminated from financial reporting. However, stakeholders and users of financial reporting may need to reach a compromise on the level at which conservatism may be practiced. Furthermore, we conclude that perspectives on conservatism on financial reporting cannot be generalised giving other social-economic variables which are peculiar to a reporting entity. Finally, we recommend that African countries may need to corroborate or refute findings emanating from the developed economy on accounting conservatism.

Keywords: Accruals, Conservatism, Financial reporting, Financial Statements, Management

1. Introduction

Among several key concepts and principles applicable in financial reporting, none has been giving much theoretical, empirical and other attention as conservatism. In the recent

times the issue of conservatism has generated much debate among entities, stakeholders, standard setters and more importantly users of accounting information. While some users are in support of the practice, there are some who are quite indifferent and lastly, there also exists users who are adverse to conservatism. In the accounting literature, conservatism has been given several consideration vis-à-vis its effects on the quality of financial reporting, corporate governance, investment efficiency, solvency and liquidity of firms, among others. Despite this enormous empirical contribution, the appropriateness of conservatism is yet to be agreed upon by scholars and users. Besides, Artiach, Clarkson, and Olesen (2012) also reported that there is a conceptual and methodological inconsistency surrounding the subject of conservatism. It is against this background, this paper set out to review the literature on the subject matter thereby putting into perspective its conceptualization, theoretical background, operationalization alongside empirical evidence from studies in developed, emerging and developing economies. The rest of this paper is structured as follows. Section two discussed the conceptualization of accounting conservatism, section three reviews various methodological and operational constructs of conservatism;

section four consists of reviews of relevant theories that explain accounting conservatism, while section five is on the review of empirical studies and section six gives a concluding remarks.

2. Conceptual Review

Generally speaking, conservatism is derived from the idea of exercising caution in recognising. Accounting conservatism has been viewed and defined by several authors and from different perspectives. Historically, the concept of conservatism is based on the accounting tradition of ‘anticipate to profits but anticipate all losses’ (Bliss, 1924). This definition appears simple and succinct; however, in the opinion of Devine (1963) accounting conservatism is beyond curtailing profits and anticipating losses. He submitted that accounting conservatism has to do with accounting information, the users of the information and the firm. Belkaoui (1985) and Watts & Zimmerman (1986) claimed that accounting conservatism implies reporting lowest value of assets and revenues and the highest value of liabilities and expenses. Feltham and Ohlson (1995) defined accounting conservatism as “the persistence in underestimating the book value of the firm. This definition is similar to that of Ruch and Taylor (2006) who defined accounting conservatism as “accounting policies or tendencies that result in the downward bias of accounting net assets value relative to economic net asset value.” This definition addresses conservatism as a difference between the economic valuation and accounting valuation of firms’ assets adjusting for risk of uncertainties. While the preceding definitions represent the opinion of individual scholars, accounting standard setters also proffer definitions on the subject matter. As published in the Financial Accounting Standard Board’s (FASB)

Statement of Financial Accounting Concepts (SFAC) No. 2, conservatism was defined as “prudent reaction to uncertainty to try to ensure that uncertainties and risk 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 estimates” (FASB, 1980). In the view of the International Accounting Standard Board (IASB), conservatism was defined as prudence in the inclusion of a degree of caution in the exercise of the judgment needed in making the estimates required under condition of uncertainty such that assets and income are not overstated and liabilities and expenses are not understated.

Although these definitions are useful and insightful in describing conservatism, they do not consider the actual economic environment and do not distinguish different types of conservatism, hence making the measurement and operationalization of accounting conservatism difficult (Zhong and Li, 2016). As an improvement on the existing definitions and conceptualizations of accounting conservatism, Basu (1997) proposed another angle to defining accounting conservatism coupled with an insightful model to measure it. He defined accounting conservatism as “accountants’ tendency to require a higher degree of verification to recognise good news as gains than to recognise bad news as losses”. This definition seems to have a larger acceptance among accounting researches. For instance, Ball, Kothari and Robin (2000) point out that Basu’s definition actually explains conservatism as the extent to which current-period accounting earnings asymmetrically incorporates economic losses relative to economic gains.

As a general appraisal of all the above definitions, accounting conservatism could be summarised as the scepticism and caution exercised by preparers of financial statements in recognising material financial transactions characterised with uncertainties in the financial statements with the goal of presenting relevant and reliable financial information to meet the need and yearnings of various users.

2.1 Perspectives on Accounting Conservatism

The application of conservatism in financial reporting has been widely debated in the accounting literature (Zhe Wang, 2009). For over 15 years, conclusion as to whether conservatism reporting is appropriate or inappropriate is yet to be reached. While there are proponents to the practice of conservatism, there are also opponents to the practice (Devine, 1963; Levitt, 1998) hence, a cogent gap in the accounting literature on the subject of conservatism. In a bid to classify the effect of conservatism on financial reporting, Ruch and Taylor (2015) identify two major effects of conservatism on financial statements. Firstly, accounting conservatism affects the financial statements numbers (i.e. reported figures) and secondly, accounting conservatism affects users of financial statements. The implication of the above is that accounting conservatism is not all about prudence, but includes downward bias in accounting figures. Furthermore, conservative reporting also has a direct effect on the decision making of users of financial statements since they often base their decisions largely on the reported figures in the financial statements. As a rebuff to conservative reporting, Hendriksen (1982) argued that conservatism is, at best, a very poor method of treating the existence of uncertainty in valuation and income, at its worst; it results

in a complete distortion of accounting data. Still on arguments against conservatism, Chatfield, (1996) summarised some of the most frequently used arguments against conservatism into two. Firstly, that accounting conservatism is not consistent since it produces lower income in one period and leads to higher income in another period and secondly, accounting conservatism is arbitrary and gives manager too much discretionary power over reporting. Lastly, Niclas, (2008) posited that the idea of systematically understating assets and overstating liabilities, recognising revenues too late and expenses too early has been interpreted as a way of reducing the relevance of accounting information.

In addition to the arguments of scholars, the accounting standard setters who previously subscribed to conservative reporting now classify such as a bias and non-neutral principle of financial reporting. In 2006, the FASB and IASB in an attempt to harmonize the framework of financial reporting exclude the conservatism principle from the conceptual framework on the basis that it is bias and not objective. In the light of this, “faithful representation” which translates to completeness, neutrality and freedom from error was introduced into the accounting lexicon. Hence, IASB now advocates “fair value” reporting in place of conservative reporting (Charles, Pascal and Remi, 2011). As expected, the exclusion of conservatism from the conceptual framework is not without critic. For instance, Zhe Wang (2009) posit that if conservatism is replaced by neutrality as argued by the IASB and FASB, firms will likely adopt sub-optimal accounting techniques that will impair their economic efficiency. Also, Zhong and Li, (2016) reported that “bias” which is the main argument for the exclusion of conservatism from the conceptual framework should not always be assumed to

be undesirable, especially in circumstances when bias, in the view of the managers, produces information that is more relevant to some users.

While the views and dissenters of conservatism may be tenable and justifiable, other authors (Zhong and Li, 2016) have argued for the appropriateness and importance of conservatism in financial reporting. However, of all the proponents of conservatism, the arguments of Watts (2003) have been widely embraced in the accounting literature. Watts (2003) posited that “the long survival of conservatism and its apparent resilience to criticism strongly suggests that conservatism critics overlook its significant benefits. If regulator and standard-setter critics try to eliminate conservatism without understanding its benefits, the resultant standards are likely to be seriously detrimental to financial reporting”. He identified four (4) main factors as the reasons why incorporating conservatism in financial reporting may be necessary. These are contracting, taxation, litigation and regulation. In his opinion, the foremost justification for conservatism is contracting, which he summarises from three perspectives namely debt covenants, compensation contracts and corporate governance. In debt covenant, Watts (2003) argued that conservatism minimises the possibility of management forgoing positive net present value projects, overstating earnings and net assets, and treating equity shareholders with preference at the expense of debt-holders. This suggested that conservatism is a way of ensuring that managers efficiently utilised debt financing; a default of which may lead to take-over from debt-holders. In compensation contract, conservatism reduces the tendency of management overstating net assets and cumulative earnings in order to distribute the net assets of the firm to themselves instead of instead of exerting effort to undertake

positive net present value projects. Hence, conservatism is a means of curtailing management opportunistic behaviour from overstating or window dressing financial statement, and thereby making payment to themselves and other parties such as shareholders. It is however belief that the elimination of management opportunistic behaviour through conservatism accounting will increase the firm value. It is also belief that there is an agency problem between shareholders and managers and that accounting conservatism facilitates shareholders’ ability to mitigate this agency problem through timely loss recognition, and further enhance a good corporate governance practices.

A further justification for conservatism as argued by Watts is the fact that it minimises unnecessary taxation expenses and facilitates deferred payment of tax. It is argued that asymmetric recognition of gains and losses enables managers of profitable firms to reduce the present value of taxes and increase the value of the firm. On litigation, he argued that overstating the net assets of a firm may possibly generates litigation cost than understating the values of such firm net assets. Hence, it is argued that the inclusion of conservatism in the preparation of financial statements will reduce predicted litigation costs. Lastly, Watts (2003) posited that accounting conservatism will reduce regulatory bottleneck and reduced criticism arising from firms overstating their financial statements. As evidenced in the Enron scandal, it is argued that encouraging conservative reporting will reduce the political cost of the regulatory body and also will curtail management excesses in the preparation of financial statements. However, arguments of Watts (2003) are not without empirical justification. For instance, Zhang (2008) submitted that accounting

conservatism payoff both lenders and borrowers in the debt contracting process. Furthermore, Schipper (2005) opined that lenders may protect themselves by writing conservatism contracts without requiring biased reporting.

2.2 Taxonomy of conservatism

By extending the scope of conservatism, accounting researchers have begun to distinguish different classification of accounting conservatism in order to enhance targeted and focused research (Basu 1997; Beekes, Pope and Young, 2004; Ruch and Taylor, 2016). Beaver and Ryan (2005) classify accounting conservatism into unconditional and conditional conservatism. Unconditional conservatism also referred to as news-independent or *ex ante* conservatism, occurs when accounting net assets are consistently under-value without any recourse to economic news events. In effect, unconditional conservatism follows a pre-determined valuation principle applied on assets or liabilities for the purpose of achieving a particular goal or reaching a particular financial target. Examples of unconditional conservatism includes accelerated depreciation methods, immediate expensing of the cost of internally generated intangible assets and the amortisation of long lived assets at a rate above the expected economic amortisation rate.

On the other hand, conditional conservatism alternatively called news-dependent or *ex post* conservatism takes place when bad economic news is recognised in accounting earnings in a prompt (timelier) manner than good economic news. It then follows that conditional conservatism is characterised by the asymmetric recognition of positive (good) and negative (bad) economic news. Examples of conditional conservatism

include goodwill impairment, long lived assets impairment, inventory recorded at the lower of cost or market value. According to Ball, Robin and Wu (2003), a further distinction between unconditional conservatism and conditional conservatism is that conditional conservatism carries new information which are often induce by the happening in the economic environment of the organisation.

Both unconditional and conditional conservatism have been observed to have different effects on financial statements. Scholars (Ruch and Taylor, 2016; Beaver and Ryan 2005) have further distinguished between conditional conservatism and unconditional conservatism. Firstly, the two forms of conservatism have different effects on the income statement. Ruch and Taylor (2016) posited that the application of accounting policies consistent with unconditional conservatism is likely to have a relatively consistent impact on the income statement from period to period. On the contrary, the application of conditional conservatism is more likely to be transitory on the income statement because of inconsistency in the content and timing of economic news across periods. However, on the statement of financial position, both type of conservatism result in understated net assets. Nevertheless, there is a timing difference on how they are recognised. Secondly, some studies observed that the application of one type of conservatism affects the application of the other type. While investigating the relationship between conditional and unconditional conservatism, Beaver and Ryan (2005) observed that unconditional conservatism creates “accounting slack” that may pre-empt the application of conditional conservatism. This actually means that unconditional understatement of assets limits the magnitude of write-down recognised in the

presence of bad news events, and therefore, reduces observed asymmetric timeliness in earnings. Consequently, the effect of conditional conservatism may not be truly represented on the face of financial statements due to the slack created by the application of unconditional conservatism. Thirdly, conditional conservatism can improve contracting and investment efficiency (Ball and Shivakumar, 2005), through the timely recognition of negative economic news and thereby reducing managers' opportunistic behaviour. Unconditional conservatism may not offer such agency problem panacea, hence, Qiang (2007) concluded that conditional conservatism and unconditional conservatism have a negative relation with each other and play different roles in firm.

Since conditional and unconditional conservatism have different effects on financial statements, it is important for researchers to be specific on the form of conservatism to investigate in their scholarly arguments. For instance, (Penman and Zhang, 2008; Jackson and Liu, 2010; Monahan, 2005; Balachandran and Mohanram, 2011; Mensah, Song and Ho, 2004) have carried out studies relating to unconditional conservatism while (Kim and Kros, 2005; Dichev and Tang, 2008; Bandyopadhyay, Chen, Huang and Jha, 2010; LaFond and Watts, 2008; Kim, Li, Pan and Zuo, 2013; Francis, Hassan and Wu, 2013; Garcia Lara, Garcia Osma and Penalva, 2011; Helbok and Walker, 2004; Louis, Lys and Sun, 2014; Pae and Thornton, 2010; Wittenberg-Moerman, 2008; Francis and Martin; 2010) have all carried out studies relating to conditional conservatism. Nevertheless, there also exist studies incorporating the two forms of conservatism (Ahmed and Dulleman, 2007; Zhang, 2008; Chan, Lin and Strong, 2009; Francis, et al

2013; Hui, Matsunga and Morse, 2009; Chen, Folsom, Peak and Sami, 2014).

Another classification type of conservatism is discretionary conservatism versus non-discretionary conservatism (Lawrence, Sloan and Sun, 2013). This is similar to discretionary earnings and non-discretionary earnings. Lawrence, et al. (2013) viewed non-discretionary conservatism as an unbiased application of accounting principles in the valuation of economic assets such that downward valuation of assets is justified beyond reasonable doubt, while discretionary conservatism is that arising from intentional manipulation in the financial reporting process to adjust for uncertainties in timing and amount of financial transactions. In response to this categorization, Roychowdhury and Martin (2013) opined that non-discretionary conservatism may rather be viewed as "normal conservatism" that is, a form of conservatism that is necessary given the economic circumstances that surrounds a firm while discretionary conservatism may be viewed as the variance between the level of normal conservatism or expected conservatism and the actual level of conservatism. In effect, discretionary conservatism is the residual of actual conservatism less normal conservatism. However, according to Watts, (2003); Jensen and Meckling, (1986) it may be difficult for firms to operate at the normal level of conservatism given the agency conflict between managers and shareholders.

3. Methodological Issues

The effect of accounting conservatism cannot be properly ascertained without an accurate measure or representation consequently, scholars have developed several models for the measurement and operationalization of accounting

conservatism. As evident from the literature five (5) key measures of conservatism are prominent. These five (5) measures alongside their proponents are explained further in this section

3.1 Feltham and Ohlson (1995): Book-to-Market (BTM) or Market-to-Book (MTB) Ratio

The BTM measure of conservatism is rooted on the assumption that conservative accounting practices will produce a net book value that is relatively low to the true economic value of a firm. Hence, a higher MTB (or a lower BTM) indicates higher degree of conservatism and vice versa. The MTB measure was predicated on the Residual Income Valuation Model firstly introduced by Feltham and Ohlson (1995) However, Beaver and Ryan (2000) argued that the MTB ratio is a noisy measure of conservatism, therefore, they decompose the BTM ratio into two components namely: the bias component and the lag component. Beaver and Ryan explain the bias component on the assumption that book value is persistently higher (lower) than the market value such that the BTM ratio is persistently above (below) while the lag component connotes an unexpected economic gains (losses) that are recognised in the book value over time rather than immediately such that the BTM ratio is temporarily lower (higher) than it means (i.e its original value without bias) but tends to approach its original status over time. Beaver and Ryan (2000) argued that only the bias component can best be used to measure conservatism. However, in order to decompose the BTM into its bias and lag variant, Beaver and Ryan (2000) put forward the following fixed effect panel data regression:

$$BTM_{it} = a_t + a_i + \sum_{j=0}^6 \beta_j ROE_{i,t-j} + \varepsilon_{it}$$

Where:

BTM_{it} – book-to-market (BTM) ratio of firms at the end of year t

a_t – year-to-year variation in the BTM common to the sample firms

a_i – bias component of the BTM for firms

ROE_{it} - return on equity (ROE) in each of the six years preceding year t

β_j – regression coefficient on $ROE_{i,t-j}$

As explained by Beaver and Ryan (2000), the intercept a_t is fixed for all firms in any particular year, but may vary from year to year. Therefore, a_t captures the point time effect of market wide BTM movements. The fixed effect coefficient a_i captures the firm specific persistent bias component of BTM for firm i , and is fixed for each firm. β_j is the regression coefficient of the lag component of the BTM ratio. As stated earlier, Beaver and Ryan (2005) argued that a more accurate measure of firm's degree of conservatism is the bias component of BTM rather than the basic BTM. The BTM measure has been widely applied in the accounting literature in measuring conservatism, however, due to its large dependence on managers' discretion (i.e. in persistently decreasing (increasing) book value) and non-dependence on economic news it is viewed by accounting scholars as an appropriate measure of unconditional conservatism. Zhe Wang (2009) argued that firstly, the strength of the BTM measure of conservatism is that it is firm-specific compared to the AT measure and the AACF measure. Secondly, BTM measure has the theoretical foundation of Feltham and Ohlson's (1995) RIVM model, a widely applied valuation model in the accounting literature. Notwithstanding the strength of BTM measure, Roychowdhury and Watts (2007) opines that the MTB ratio may be a biased estimator of the degree of conservatism due to the existence of economic rents in most firms. they argued that since economic rent cannot be measured

reliably and hence does not fulfil the recognition criteria its non-inclusion in the book value of the firm will definitely depress the ratio of the book value to market value, consequently, the higher the economic rent a firm has, the more likely its MTB (or BTM) ratio overstates (understates) the actual level of conservatism of such firm. it therefore follows that only if the firm has no economic rent will its MTB ratio be assumed to be an unbiased estimate of a firm's real degree of conservatism. Another weakness of the BTM ratio is that the BTM is a well-known proxy for many factors other than accounting conservatism as evidenced in the accounting and finance literature therefore it is prone to interpretation problem. despite the weaknesses of the BTM measure several studies such as Roychowdhury and Watts (2007); Qiang (2007); Pae et al. (2005); Mason (2004); Lara, Osama, Penalva, 2009); Lara and Mora (2004); Gassen, Ibier and Sellhorn, 2006); Beatty, Weber and Yu, 2008); Ahmed et al (2002); Ahmed and Dulleman (2007) have all conducted studies using the BTM ratio as a measure of conservatism..

3.2 Basu's (1997) – Asymmetric timeliness of earnings (AT)

Basu (1997) in his pioneering work “the conservatism principle and the asymmetric timeliness of earnings based his measure of conservatism on how accounting earnings reflects bad economic news quickly than good economic news. To determine the extent of conservatism, Basu used stock returns as a signal for positive and negative economic news and posit that the effect of these signals can be easily seen on accounting earnings. In other words, Basu posit that under conservatism bad news are reflected in earnings quickly than good news.

Consequently, the model used accounting earnings as the dependent variable which reflect the impact of good news and bad news, and annual stock returns as the proxy for good news and bad news. The construct of the Basu's model is as shown below:

$$\frac{EPS_{it}}{P_{it-1}} = a_0 + a_1DR_{it} + \beta_0R_{it} + \beta_1R_{it} * DR_{it} + \mu$$

Where:

EPS_{it} – accounting earnings per share for firm i year t

P_{it} – opening stock market price for firm i year t

R_{it} – stock market returns for firm i year t

DR_{it} – Dummy variable that is equal to zero (0) if the stock market return for firm i in year t is positive or equal to zero, and one (1) if the stock market return for firm i in year t is negative.

As explained by Basu (1997), the β_1 coefficient in the model captures the sensitivity of earnings to bad news. Therefore β_1 is the measure of conservatism. A significant positive β_1 indicate the existence of conservatism in the sample, otherwise, the sample is attributed to be non-conservative. The strengths and weaknesses of Basu's model have been discussed extensively in the literature. For instance, Farrrokh, Mohammad and Soroush (2015) argued that the assumption that negative stock return is an outcome of conservatism is not conclusive. They debated that there may be other factors that may account for negative stock returns other than conservatism. Givoly and Hyan (2000) further argued that Basu's measure shows poor performance in time series research design and that it does not work well when information is aggregated over a time period. Beaver and Ryan (2000) also posit that there is simultaneity problem in the

relationship between earnings and stock returns.

Despite the criticism of Basu's model, Ryan (2006) identified some strength in the model. Firstly, the Basu's model is the most widely used measures of conservatism and secondly, empirical research using the AT measures have produced results that are consistent with their theoretical predictions which increases researchers confidence not only in the theory but also in the measure itself. In addition to his support for AT measures Ryan (2006) is of the opinion that the Basu's model may be improved upon by incorporating other variables aside stock returns that may account for conservatism. To further lend credence to the AT measures studies like Ahmed and Dulleman, (2007); Ball, Robin and Sadka, (2008); Beaver, Landsman and Owen, (2008); Beekes et al (2004); Bushman and Piotroski (2006); Choi (2007); Dietrich and Tang. (2008); Francis et al. (2004); Giner and Rees (2001); Givoly et al. (2007); Huijgen and Lubberink (2005); Krishnan (2005); LaFond and Roychowdhry (2008); LaFond and Watts (2008); Lobo and Zhon (2006) have all measures conservatism using the Asymmetric timeliness (AT) measures.

3.3 Givoly and Hyan (2000): Non-Operating Negative Accruals

The non-operating negative accrual as a measure of conservatism is credited to Givoly and Hyan (2000). The authors posit that accounting conservatism can be proxy by the magnitude of negative accruals evident in the financial statement of an entity overtime. Givoly and Hyan (2000) justify this measure on the basis that accounting conservatism uses the mechanism of accruals to defer the recognition of economic gains and accelerate the recognition of economic

losses in that earnings are usually recognised on an accrual basis, therefore, timely loss recognition and gradual gain recognition will result in negative net accruals, hence, the higher the level of cumulative negative accruals the higher the level of conservatism. However, to capture negative accruals, Givoly and Hyan put forward the below equation

$$NA = TACC - OPACC$$

Where:

TACC – Total Accruals represented by (Net income after depreciation – net cashflow from operating activities)

OPACC – Operating Accruals represented by Δ inventory + Δ Receivables + Δ Other current assets – Δ payables – Δ other current liabilities

Zhe Wang (2009) identifies the strength and weaknesses of NA measures of conservatism.

Firstly, NA measure is a firm-specific measure of conservatism. Secondly, the NA measure is quite easy to analyse as it does not require many data items. In addition, NA measure is not market-based, therefore, in contrast to Basu (1997) and MTB measure, it is suitable for both public and private firms. Notwithstanding the strengths of NA measure, Zhe Wang (2009) point out the following weaknesses in the NA measure. Firstly, since NA uses accumulated accruals over an extended period of time, the selection of a base year is difficult to standardise across firms. Nevertheless, studies like Lara et al. (2009); Ahmed and Dulleman have used average non-operating accruals over three (3) years and this approach further forfeit the "accumulated" aspect of the measure thereby making it "average". Another weakness of NA measure is that it does not have a specific threshold a non-negative accruals must reach for a conservatism to be ascertained. NA measure has not been given wide

application in the accounting literature as AT measures hence, researcher may test the validity of this measure to validate its robustness. Notwithstanding its few patronage by accounting researches studies like Zhang (2008); Qiang (2007); Mensah, Song and Ho, (2004); Klien and Marquardt (2006); Gassen et al. (2006); Beatty et al. (2008); Ahmed and Dulleman (2007) have all measured accounting conservatism using the NA measures.

3.4 Penman and Zhang (2002): The Hidden Reserves Measure (HR)

Penman and Zhang (2002) propose the hidden reserve measure for accounting conservatism. They argued that prompt recognition of negative economic news and

delay in recognising positive economic news creates hidden reserves hence the magnitude of hidden reserve inherent in a firm's financial report can be used to determine the degree of conservatism. Consequently, a firm with higher amount of hidden reserve is said to be highly conservative and vice versa. Despite the novelty of this measure, it is deficient in that hidden reserves are not usually reported in the financial statement therefore; the estimation of hidden reserve is usually based on the discretion of analysts. However, notwithstanding the measurement problem associated with HR, there are two common measure of hidden reserve as discussed in the literature.

Firstly, Ahmed and Dulleman (2000) use two ratios which are:

$$\frac{\text{Research and Development}}{\text{Sales}} \quad \text{and} \quad \frac{\text{Advertising expenses}}{\text{Sales}}$$

as proxies for hidden reserves. these proxies seems not to be appropriate measure for researchers hence Penman and Zhang (2002) proposed another method for measuring hidden reserves by putting forward another measure also known as *Cscore* in measuring conservatism. The formula of Penman and Zhang (2000) for measuring conservatism is presented thus:

$$C_{it} = \frac{ER_{it}}{NOA_{it}}$$

Where:

ER_{it} = estimated hidden reserve created by accounting conservatism of firm i at time t

NOA_{it} = Net operating assets calculated as the book value of operating assets minus operating liabilities, excluding financial assets and liabilities.

In estimating ER_{it}, Penman and Zhang (2002) proposed the formular below:

$$ER_{it} = INV_{it}^{res} + RD_{it}^{res} + ADV_{it}^{res}$$

Where:

INV_{it}^{res} = inventory reserve

RD_{it}^{res} = R&D reserve

ADV_{it}^{res} = Brand assets

In accordance with the US GAAP INV_{it}^{res} are reported in the footnotes to the financial statements while R&D reserves and Brand assets are calculated by firstly capitalising all R&D expenses from the income statement as if R&D were an asset and

secondly amortise the balance of capitalised R&D assets using the estimated average industry rate of amortisation. The resulting R&D asset after amortisation is the RD_{it}^{res} . Similarly, the advertising reserve ADV_{it}^{res} (an estimated brand assets) is derived by

first capitalising all advertising expenses and then amortising them, the resulting figure after amortisation is the ADV_{it}^{res}

3.5 Ball and Shivakumar (2005): Asymmetric Accruals to Cashflow Measures (AACF)

In order to cater for the shortcomings of Basu’s (1997) measure of conservatism which is only suitable for publicly listed or quoted companies because of the availability of stock price information, Ball and Shivakumar (2005) developed the AACF measure which may be suitable for measuring the degree of conservatism in private and unlisted companies since they have no stock price information. The AACF measure is quite similar to AT measure, however, the explanatory variables for conservatism differs. While Basu make use of stock returns as a proxy for economic news, Ball and Shivakumar (2005) captures this by using cashflow. Also, the response variable which will react to conservatism captured as earnings in AT measure was represented by Accruals in the AACF measure. AACF measure selects only the accrual components of earnings on the argument that accounting conservatism mainly influences the accrual components of earnings rather than the cashflow components. the construct of AACF measure of conservatism is presented thus:

$$TACC_{it} = \beta_0 + \beta_1 DCFO_{it} + \beta_2 CFO_{it} + \beta_3 CFO_{it} * DCFO_{it} + \mu_{it} \dots \dots (2)$$

Where:

- ACC_{it} – operating accruals measured as $\Delta inventory + \Delta receivables + \Delta other\ current\ assets - \Delta payables - other\ current\ liabilities - depreciation$
- DCFO – dummy variable that is set to zero (0) if cashflow from operating activities is

positive or equal to zero, and is set to (1) if negative
 CFO_{it} – cashflow from operating activities for period t

In AACF the measure of conservatism is captured by coefficient β_3 in the above regression equation. A higher β_3 indicates a greater degree of conservatism and vice versa. The AACF measure has not been accorded much criticism in the literature due to the fact that it is a relatively new measure and its robustness is yet to be validated. However, studies like Pae (2007); Lara et al. (2009a); Krishnan (2007); Bushman and Piotroski (2006); Brown, He and Teitel, (2006) have all examined accounting conservatism using the Ball and Shivakumar’s Model. This shows that the AACF measure rate of acceptability is growing by the day.

4. Theoretical Review

The concept of conservatism is established in most corporate governance theories more apparently, in the agency and stakeholders’ theory, hence, an appraisal of the theories as it relates to accounting conservatism.

4.1 Agency Theory

The agency theory as explained by Jensen and Meckling (1976) stated that there exist an agency contract between the shareholders (principal) of an organisation and its management (agent). The theory further states that the relationship between the duo is such that both parties have conflicting objectives as to the management of the firm. As described by the Jensen and Meckling, the shareholders want to maximise their income and wealth by way of receiving dividend and enjoying increment in the value of their holdings while the managers on the other hand do not have interest in the

objectives of the shareholders but are concerned with receiving remuneration and all other benefits at the expense of the shareholders. Hence, in financial reporting both parties are interested in ensuring that the financial statement is prepared to suit their independent need. From the principal point of view, agency theory can be used to explain the need for conservative accounting. For instance, by requiring companies to recognize bad news earlier than good news forces managers to incorporate negative economic event into earnings earlier which in a way minimises the agency conflict. Furthermore, managers are always forthcoming with good news rather than bad news, by adopting conservative accounting managers are compelled to report negative economic news as fast as possible thereby reducing their incentives and mitigating information asymmetry (Wei Shi and Haifen, 2016). It is therefore obvious that managers are averse to conservative reporting since it minimises the volume of returns and incentives accruable to them. Hence, accounting conservatism conflicts the interests of the principal and its agent.

4.2 Stakeholders Theory

The stakeholders theory as published by Freeman (1983) was hinged on the proposition that an organisation is responsible not only to its shareholders but to other agents that are interested in its operations and activities. According to the theory, organisation must ensure proper management of its stakeholders via accurate financial reporting and timely reaction to issues sensitive to the interest of the stakeholders. In most cases, managers are fond of impressing users of financial statement by being positive in the content of financial statement. As a result they tend to overstate profits or delay the reporting of

negative economic news. As expected, stakeholders are much interested in firms reporting higher returns and such firm has the tendency of higher patronage from the public. Consequently, since stakeholders' patronage often rely on the performance and attractiveness of the financial statements; managers tend to be cautious in incorporating transactions that may be detrimental to the attractiveness of the financial statement and thereby losing favour with stakeholders. Hence, it can be infer that managers are averse to conservative reporting as would have been expected by shareholders and other stakeholders.

A general appraisal of the above theories in relation to accounting conservatism point to the fact that the concept of timely recognition of negative economic news in the financial statement may pose some level of inconsistency in the figures reported in the financial statements given the aggressiveness of the managers to satisfy their interest and also appear to be effective in the face of their employer (Principal). Hence, the concept of conservatism which has positive and negative effects on both parties (principal and agent) interest must be well understood by all parties interested in the activities of an entity.

5. Studies in Accounting Conservatism

5.1 Evidence from Developed Economy

Panayotis, Jordann and Irimi (2011) examines how conservatism impact value relevance of accounting information in the code law (Germany, France and Greece) and common law (United Kingdom) European companies using the Basu (1997) and Easton and Harris (1991) to explain conservatism and value relevance respectively. The study submits that conservatism exists in all

countries before their IFRS adoption and that its level has decreased after 2005 only in France and Germany. The study also observed decline in the value relevance of accounting earnings in code-law countries after the adoption of IFRS, however, the UK reported high level of accounting information value relevance in the post-IFRS adoption era. Charles, Pascal and Remi (2011) examined the impact of IFRS on accounting conservatism within Europe capitalising on the role of auditors. The study extends the Basu's (1997) model to examine the direct impact of IFRS on accounting conservatism. Findings of the study show that conditional conservatism has decreased under IFRS adoption for mandatory adopters. More importantly, the study also report that mandatory IFRS adoption has diminished accounting information quality.

Paul, Andrei and Luc (2013) investigate the effect of mandatory IFRS adoption of conditional conservatism in Europe using a sample of 7,251 firm-year observations drawn from 16 European countries. The study adopts three conservatism measures proposed by Basu, (1997), Ball and Shivakumur, (2005) and Khan and Watts, (2009). Findings of the study revealed that there is a decline in the degree of conservatism across the three measures. More importantly, the study report that conditional conservatism significantly reduced after the adoption of IFRS particularly in the firms that report in the statement of financial position intangible assets and the impairment of goodwill. The authors however argued that IFRS are inherently conservative, but that inappropriate application of conditional conservatism principles may have prevented financial reporting from reaching the level of conservatism targeted by IASB. Similarly, Bin, Danqing and Zili (2013) also

investigates the impact of IFRS adoption on accounting conservatism using listed firms from 17 European countries within the period of 2005-2008. Applying the Basu's (1997) conservatism measures, the findings show that IFRS adoption has no effect on the degree of accounting conservatism for non-financial firms. however, for financial firms in a strong legal enforcement countries, the study report that there exist some weak evidence that mandatory IFRS adoption increases the level of accounting conservatism and on a contrary part, there exist a decrease in accounting conservatism for financial firms domiciled in weak legal enforcement countries.

Olga, Mariano, and David (2017) examined the effect of IFRS adoption on the unconditional conservatism of Spanish listed firms using a regression model. The study concludes that the adoption of IFRS has had no effect on the unconditional conservatism of Spanish listed companies. Similarly, Mauricio and Jose (2013) also investigate the effect of mandatory IFRS adoption on accounting conservatism of reported earnings in Chilean capital market. Using a conditional conservatism model, the author analyses the effect of conservatism in pre- and post- IFRS adoption period in 95 listed firms over a period of 12 years. Findings of the study revealed that conditional earnings conservatism is more pronounced under IFRS Standards and suggests that the use of IFRS improves the relevance of accounting information.

5.2 Evidence from Emerging Economy

Some authors have provided empirical findings to ascertain the influence of conservatism on financial report quality. Mohammadreza and Mahboubeh (2014) examined the relationship between conservatism and earnings quality of Indian

firms. The study sampled 135 firms covering the period of 7 years using regression model and equality test comparison, the result shows that there is a direct relationship between conservatism and earnings quality. The result of this study is also consistent with the findings of Marselinus (2015); Mohammad, Farough and Nezam (2013). Also, Stephen and Xiao-Jun (2002) also investigate the impact of accounting conservatism on the quality of earnings and stock returns. The study concludes that conservatism accounting has hampered the quality of earnings and return. Nurzi and Yuanita (2016) examine the effect of accounting conservatism on the value relevance of accounting information of listed firms in Indonesia Stock Exchange. The study adopts the Basu (1997) and Easton and Harris (1991) model in explaining conservatism and value relevance respectively. Findings of the study show that value relevance of accounting information flows with the level of conservatism. That is, accounting information has high value relevant in a less conservative financial report and low value relevant in a high conservative financial reporting. Similarly, Mehpare (2013) in his study conditional conservatism and value relevance of earnings observed that accounting conservatism has a negative impact on value relevance of earnings. This finding lends credence to the IASB stance on the exclusion of conservatism from its conceptual framework. Still on conservatism and value relevance of accounting information, Dimitrios, Anestis and Christos (2010) also examine the value relevance of accounting information in the pre- and post-IFRS adoption era in Greece using the Basu (1997) and Feltham and Ohlson (1995) models to explain conservatism and value relevance, the findings of the study revealed that explanatory power of earnings information significantly increase in the

post-IFRS period. While investigating the effect of mandatory IFRS adoption on accounting conservatism of reported earnings in the Chilean markets, Mauricio and Jose (2013) found out that conditional earnings conservatism is more pronounced under IFRS standards and suggests that the use of IFRS improves the relevance and reliability of accounting information.

Chan, Lin and Strong (2009) investigate the economic consequences of unconditional and conditional conservatism on equity investors. The study adopts Ohlson and Juettner-Nauroth model to estimate cost of equity while the Basu (1997) model was used to measure the rate of conservatism. Findings from the study indicate that unconditional conservatism is associated with higher quality of accounting information and lower cost of equity while conditional conservatism is associated with lower quality of accounting information and higher cost of equity. Garcia, Garcia and Penalva (2011) test the association between conditional conservatism and cost of equity capital. The study adapts the asset-pricing model in assessing the impact of conservatism on cost of equity. Findings from the study indicate that there is a significant negative association between conditional conservatism and cost of equity capital. Similarly, the report of Tracy and Peter (2010) in their examination of the individual and joint effect of conservatism and disclosure on the cost of equity capital shows that there exist an inverse relationship between the level of conservatism and the cost of equity, however, this impact is reduced in an environment characterised with high level of disclosure. Gary, Mary and Feng (2016) provide a contrasting view on the relationship between conditional conservatism and cost of equity. Their study adapts the asset-pricing model in explaining the relationship between unconditional conservatism and cost of equity. Findings

from the study show that there is a significant positive relationship between conditional conservatism and the cost of equity capital. Similarly, Maha and Hakim (2015) investigate the economic consequence of conservatism and the cost of equity capital in the Middle Eastern and North Africa (MENA). The study adopts the Basu model in measuring conservatism and the asset pricing model to examine to examine the effect of conservatism on cost of equity capital. Findings of the study show that there exist a negative association between conservatism and the cost of equity capital. In support of these findings, Heba and Mamoun (2017) also conclude that conservatism has a significant negative effect on the cost of equity of Jordanian firms

6. Concluding Remarks and Recommendations

The debate on conservatism has been given wide consideration in the accounting literature especially in the developed and emerging economies. However, not many studies have examined the existence of conservatism in or its effect on financial reporting in the most African countries. Therefore researchers in developing countries and mostly in Africa may need to explore the issue of conservatism and its effect on financial reporting to corroborate or refute findings in the global scene. Following the conflicting submissions of scholars on the appropriateness of accounting conservatism, it is hoped that research into accounting conservatism will provide stakeholders, academics, regulatory bodies and policy makers with adequate understanding and implication of this accounting principle especially in the recent times where it is excluded from the International Accounting Standard Board (IASB) conceptual framework.

Furthermore, previous studies (Watts, 2003; Lafond and Watts, 2008 and Iyenger and Zampelli, 2010) provide evidence that accounting conservatism enhances the credibility of financial information and protects equity users from overstated firm's financial performance. However, with the recent submission of the IASB (IASB, 2006) that conservatism reporting is a non-neutral financial reporting and as such it is bias as to the quality and reliability of the content of a financial statement, there exist an inconclusive opinion as to impact of accounting conservatism on the quality of financial statements. Therefore future researchers may still need to explore this argument to contribute to the frontier of knowledge and also provide empirical findings that may guide accounting regulatory bodies

Despite the available models for measuring conservatism only Basu's (1997) AT measures have been given much relevance in the accounting literature while other measures are adjudged less appropriate. However, not one measure has been categorised to be flawless. This provides opportunities for future studies to explore the issues relating to operationalization and measurement of accounting conservatism. In addition, it is argued that if adopting IFRS will enhance the quality and reliability of financial statement, the magnitude of accounting conservatism should be reduced after the adoption of IFRS. Several studies have been conducted to evaluate the effect of accounting conservatism on financial statement credibility after the adoption of IFRS (Jian, 2011). However, findings from these studies cannot be generalised since accounting information quality is influenced not only by accounting standards but also other social-economic variables which are peculiar to a reporting entity (Ball, Kothari, and Robin, 2000; Pope and Walker 1999). Hence future studies may need to investigate

this issue especially in jurisdictions where IFRS is the dominant standard.

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