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CONSERVATISM AND ACCOUNTING ASSYMETRY IN INTERNATIONAL ACCOUNTING

ABSTRACT

The paper surveys relevant accounting methods dealing with information asymmetry, uncertainties, and harmonization implications on less developed capital markets. The quality of accounting information is related to more aggressive or more conservative accounting policy approaches. A strong impact is assumed to be given by following factors: low market liquidity, underestimation of bad debt, pre-mature revenue recognition, transfers of risks and ownerships; accounting oriented on tax purposes, introduction of maximum allowable depreciation rates, unadjusted differences in employees' benefits relevant to labor legislation; non recognition of contingency reserves for long term litigations. We draw special attention to recent International Financial Reporting Standards (IFRS) convergence to United States Generally Accepted Accounting Principles (US GAAPs), especially in harmonizing with the Financial Accounting Standards Boards statement (FAS) 130: Reporting comprehensive income (in revised IAS 1) and FAS 157 Fair value measurement. A Critical Accounting Policy Choices Index for Bosnia and Herzegovina ($CAPC_{BIH}$) resulted in a very poor performance presenting significant gap in recognizing environment specifics. Furthermore, the importance of revised International Standards on Assurance Engagements (ISAE) and re-enforced role of auditors in assessing relevance of management estimates is stressed.

Key words*: accounting conservatism, aggressive accounting, conservative accounting, accounting asymmetries, fair value measurement, risk assessment*

JEL classification*: M41*

1. INTRODUCTION

Financial reporting has recently significantly evolved: the convergence between US Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB), especially Financial Accounting Statement (FAS) 130, Reporting comprehensive income and FAS 157, Fair value measurement, enforces financial presentation and its predictive power and aligns it better with business risks and other impacts on the business environment.

The paper concentrates on the assessment of business risks and its implications on financial reporting. Moreover, it focuses on international recommendations on revised IFRSs (issued by IASB), revised IPSASs (issued by IFAC) as well as management abilities to present financial reports in accordance with changing standards.

Motivated by the global financial crisis, the sub prime crisis and big bath accounting scandals, during the period 2008 – 2010, the Financial Stability Forum (initiated by G7) issued numerous recommendations for local standard setters on Market Enhancement and Institutional Resilience in public risk disclosures and industry's efforts to identify the principles for useful risk disclosures (FSF 2010).

In 2007, the International Federation of Accountants (IFAC) conducted a survey that yielded 341 responses, aiming in figuring out the results of changes in improving financial statements, specifically, their relevance, reliability and understandability, as well as in determining next steps. The study discovered some major movements and areas of concern in term of financial reporting quality (IFAC 2008, p. 28):

- Reduced usefulness due to complexity,
- Use of fair value,
- Focus by companies on compliance instead of reporting on the essence of the business,
- Regulatory disclosure overload,
- Difficult and often changing financial reporting standards and
- Lack of forward looking information.

According to the IFAC Report (IFAC 2009, p. 25) the study was conducted among 74 IFAC members from 59 different countries and regarding the usefulness of financial reports stated:

"[...] the usefulness of financial reports: insufficient reporting on non-financial indicators, risks, and sustainability performance; the unclear link between reporting and an organization's environment and strategy and its implementation; and the use of fair value measurements in current market circumstances. [...]".

This conclusion was met in accordance with the progress analysis, conducted on country levels describing levels of jurisdiction alignments by country appealing to feedback on previously issued recommendations (Table 1).

Table 1: Indications of actions in accordance with IFAC recommendations on financial reporting quality improvement (authors' modifications)

Recommendation (%)	1	2	3	4	5	mean
1. Improve communication to determine what should be reported	15	40	42	2	2	3.67
2. Financial reports more informative including more business-driven information	15	46	34	3	2	3.69
3. Better align internal and external reporting	15	42	35	2	7	3.59
4. Promote use of technology for compilation of own information (i.e. XBRL)	15	38	38	2	8	3.53
5. Encourage short-form financial reporting	18	32	40	2	8	3.50

Note: 1 - fully addressed, 2 - partially addressed, 3 - will be addressed, 4 – not addressed, 5 – irrelevant

Source: IFAC (2009), authors' modifications

Referring to risk assessment and its implications in financial reporting, in accordance with afore mentioned recommendations, while preparing financial reports, the management should take into account business-driven information and align with internal reporting, assess all relevant risks, estimate predictive indicators for future realization of net cash flows (that is also part of new fair value measurement system) and apply those on relevant balance positions.

The paper investigates existing methods determining estimates that ensure reasonable assurance on fair and true presentation of business performance and enterprise's position, as well as management capabilities and financial audit requirements in conducting relevant estimates and valuing those.

2. ACCOUNTING CONSERVATISM AND CRITICAL ACCOUNTING POLICY CHOICES

Initially, accounting conservatism was understood as an effect of caution (uncertainty) in presenting firms' earnings measured with the earnings response coefficient (ERC) or distortion between earnings and returns on investment. This is also called information asymmetry in accounting. The higher level of conservatism, higher is the implication in ERC information asymmetry.

Though, many authors argued that accounting conservatism should imply firms' prediction power on future business performance, and, therefore be an important tool of managerial accounting. Referring to their research on accounting conservatism and management forecasts or amount of disclosures, Wan Hui et al. (2009) conclude:

'[...] evidence suggests that conservatism reduces the frequency of management forecasts. Our results support the view that conservatism reduces information asymmetry in the market and thus the incentive to disclose additional information. Conservatism also reduces management's expected litigation cost by fully disclosing the impact of bad news in a timely fashion.'

Aligning earnings and implicitly balance sheet positions to business-driven information, directly improves the reporting quality of financial statements.

2.1. Accounting conservatism measures

Primary research on accounting conservatism measures theory resulted in detecting methods relying on assumptions that accounting conservatism is subject to accounting reaction to 'bad news' on capital market against methods considering accounting conservatism as internally created mechanism adjusting financial reporting positions according to subjective business risk assessment.

Methods relying on establishment of interference between capital market and financial reporting explain conservative approach to financial reporting presentation as a result of accounting systems created to react much quicker on 'bad news' then on 'good news', i.e. in the case earnings per share are expected to decrease, accounting will adjust earnings much quicker as in opposite case.

This presumption is mostly explained in widely spread asymmetric timeliness of earnings measure or differential timeliness theory (Basu 1997):

$$\frac{EPS_{it}}{P_{it}} = \alpha_0 + \alpha_1 DR_{it} + \beta_0 R_{it} + \beta_1 R_{it} DR_{it} + \varepsilon_{it} \quad (1)$$

Whereby:

EPS_{it} Earnings per share for firm i year t
P_{it} Opening stock market price for firm i year t
R_{it} Stock markets return for firm i year t
DR_{it} Dummy variable: 1 if the stock market return for firm i in year t is negative, 0 if the stock market return for firm i in year t is non-negative.

Opposite to the differential timeliness theory, explaining accounting reactions to stock market deviations, book-to-market ratio measure (Beaver and Ryan 2002) starting point is that stock market is reaction on presented earnings. Authors are comparing book-to-market firm values against regression of Return on Equity (ROE):

$$BTM_{t,i} = \alpha_t + \alpha_i + \sum_{j=0}^{6} \beta_j R_{t-j,k} + \varepsilon_{t,i} \quad (2)$$

Whereby:

$BTM_{t,i}$	Book - to - Market (BTM) ratio of firm i, at the end of year t.
α_t	Year-to-year variation in the BTM common to the sample firms
α_i	Bias component of BTM for firm i
$R_{t-j,i}$	Return on Equity (ROE) over each of the 6 preceding years
β_j	Regression coefficients on Rt − j,i

Other group of methods explains accounting conservatism as firm's internally generated prediction of future net operating cash flows. The group is composite of Asymmetric Accrual-to-Cash flow measure (Ball and Shivakumar 2005), Hidden Reserves measure (Penman and Zhang 2002), Negative Accruals measure (Gyvoli and Hayn 2000) and Accounting Policy Choices based method (Cotter and Donnely 2006). Asymmetric Accrual-to-Cash flow measure (AACF) places bias between discounted cash flows and accruals on Inventories, Accounts receivable, Other receivables, Accounts payable and Other payables (short-term) less Amortization. Deviations are explained in term of future cash flows on operating activities predictions.

Clearly, AACF might be subject to serious consideration in process of convergence between IFRS and FAS 157, second (return slope) and third level (historical data) of fair value measurement and thereby might be used as future valuation model of all assets and liabilities.

Hidden Reserves measure (HR) introduces 'C score' as a proportion of estimated hidden reserves and Net operating assets. Estimated reserves are composite of inventories presented by LIFO allowed by US GAAP (FAS), brand value intangible and investments into research and development not capitalized.

'C score' complements to broader accounting considerations in term of R&D recognition and firm's valuation, whereby firms investing into R&D and lowering NOPAT were subject to undervaluation. Implications in Bosnia and Herzegovina could be found in modified laws on accounting and auditing obliging presentation and disclosure of annual reports including R&D positions.

Negative accruals measure (NA) relates to Residual Income Valuation Model (RIVM) or, in more concrete on the fact that accounting tends to defer the recognition of economic gains and accelerate the recognition of economic losses.
Fourth method relying on firm's internal accounting conservatism creation, Accounting Policy Choices (APC) method considers accounting policies in:

- capitalization of interest;
- goodwill written off to reserves;
- revaluation reserves;
- capitalization of development expenditures and
- valuation of quoted investments.

Measuring this way, accounting conservatism appeals to discretion in choices and mandatory valuations and as such is used in measuring convergence levels of different accounting standards, for instance FAS (US GAAP) and IFRS and its implications on relevant balance positions. The logic behind this could be found in the form 20F for foreign investors listed on US stock exchanges, their accounting principles and financial deviations caused throughout differences in reporting standards.

Special attention should be paid in term of its direct impact on accounting considerations, especially in terms of risk assessment as recommended by IFAC (2009, p 25). Author implies assumption that, by using critical accounting policy choices, the management is enabling 'cause-effect accounting' and that in the last instance ensures relevance of internal control systems, risk assessment and valuations in term of true and fair presentation of business performance and its position.

2.2. Constructing an accounting conservatism methodology

The analysis of prospective accounting conservatism index could be shaped by three different accounting and auditing standards and specificities the businesses are operating in, namely:

- IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors, Art. 32: 'As a result of the uncertainties inherent in business activities, many items in financial statements cannot be measured with precision but can only be estimated. […] For example, estimates may be required of: (a) bad debts; (b) inventory obsolescence; (c) the fair value of financial assets or financial liabilities; (d) the useful lives of, or expected pattern of consumption of the future economic benefits embodied in, depreciable assets; and (e) warranty obligations.'
- ISA 540.15: ‘For accounting estimates that give rise to significant risks, […] the auditor shall evaluate the following: (a) How management has considered alternative assumptions or outcomes […] or how management has otherwise addressed estimation uncertainty in making the accounting estimate. (b) Whether the significant assumptions used by management are reasonable. (c) Where relevant to the reasonableness of the significant assumptions used by management […], management’s intent to carry out specific courses of action and its ability to do so.’
- Low liquidity, slow courts cases, low level of cost management, underdeveloped capital market, and lack in mandatory annual valuations.

Taking into account uncertainties that understand significant management estimates, CAPC variable (Critical Accounting Policy Choices Index – CAPC) could be consolidated using a following regression model.

2.3. The Model

$$\mathrm{Re}\,v_{accountspayble} = a_0 + a_1 \alpha RAP + \varepsilon_1$$
$$\mathrm{Re}\,v_{fixedasstes} = b_0 + b_1 \beta RFA + \varepsilon_2$$
$$P_{liabilitiesandlosses} = c_0 + c_1 \gamma PLL + \varepsilon_3$$
$$\mathrm{Re}\,v_{inventories} = d_0 + d_1 \delta RI + \varepsilon_4$$
$$C_{accountspayables\&receivables} = e_0 + e_1 \varepsilon C + \varepsilon_5$$
$$I_{capacityutilization} = f_0 + f_1 \varepsilon C + \varepsilon_6$$
$$FA_{amortization} = g_0 + g_1 \eta FA + \varepsilon_7$$
$$L_{\mathrm{int}erestaccrued} = h_0 + h_1 \theta LI + \varepsilon_8$$

$$CAPC_{growth} = (\mathrm{Re}\,v_{ap} + \mathrm{Re}\,v_{fa} + P_{l\&s} + \mathrm{Re}\,v_i + C_{ap\&r} + I_{cu} + I_{isv} + L_{in}) / n \left| CAPC \right| \quad (3)$$

Whereby:

Rev $_{\text{accounts payable}}$	Revaluation accounts payable and reserves for open court cases (IAS 18)
Rev $_{\text{fixed assets}}$	Revaluation of fixed assets (IAS 16, IAS 36, IAS 38, IAS 39, and IAS 40)
P $_{\text{liabilities and losses}}$	Reserves for contingent liabilities and future losses
Rev $_{\text{inventories}}$	Revaluation of inventories to direct costing method (IAS 2)
C $_{\text{accounts payables \& receivables}}$	Confirmations on accounts payable and receivable (cut off)
I $_{\text{capacity utilization}}$	Capacity utilization – assets amortization recognized in inventories (IAS 2)
FA $_{\text{amortization}}$	Depreciation highest nontaxable vs. future economic benefits (IAS 2)
L $_{\text{interest accrued}}$	Capitalization of interest on long-term liabilities

Index range is 0 ≤CAPC ≥ 1, whereby 1 implies total absence of management abilities to estimate uncertainties, and index nearing 0 indicates management awareness of business risks, estimates and satisfactory level of prediction power (no bias). Indirectly, it can be concluded that quality of financial reporting is increasing.

Many authors argue that higher level of critical accounting policy choices directly prove management prediction power and that enables better ‘cause-effect’ accounting performance. Parallel to investigating critical accounting policy choices, survey aimed in measuring management accounting analysis intensity: Inventories management, cost management, annual plan disclosures, receivables management, liquidity and working capital analysis, result to employee ratios.

3. AUDIT ROLES IN EVALUATING ESTIMATES

Revised International Standards on Auditing, pays special attention on auditor's assurance in judging management estimates - ISAE 3400.2[i]:

'In an engagement to examine prospective financial information, the auditor should obtain sufficient appropriate evidence as to whether: (a) Management's best-estimate assumptions on which the prospective financial information is based are not unreasonable and, in the case of hypothetical assumptions, such assumptions are consistent with the purpose of the information; (b) The prospective financial information is properly prepared on the basis of the assumptions;(c) The prospective financial information is properly presented and all material assumptions are adequately disclosed, including a clear indication as to whether they are best-estimate assumptions or hypothetical assumptions; […].'

It could be concluded, that external audit will play an important role not only in evidencing management estimates, but also in capacity building concerning accounting policy choices and overall quality of financial statements.

Benston (2006) argues that, limiting liabilities to auditor's role in preventing 'income smoothening', 'big bath accounting' and/or accounting frauds in general, without risk assessment appropriately determined within accounting standards, leaves significant manipulation space for information disclosure and financial statement presentation.
In that regards ISA 3400.6 determines:

*'Prospective financial information can include financial statements or one or more elements of financial statements and may be prepared: […] (b) for distribution to third parties in, for example: • A prospectus to provide potential investors with information about future expectations. • An **annual report** to provide information to shareholders, regulatory bodies and other interested parties. • A document for the information of lenders which may include, for example, cash flow forecasts. […]'*

Taking into account recent changes in accounting legislation and mandatory presentation of annual reports enclosing risk assessment analysis, external auditors will face new challenges in obtaining sufficient evidences confirming reasonable assurance for recognized risks and its implications on relevant balance positions. Some guidance might be found in ISA 315[ii], A28.

'Examples of matters that the auditor may consider when obtaining an understanding of the entity's objectives, strategies and related business risks that may result in a risk of material misstatement of the financial statements include: Industry developments […], New products and services […], Expansion of the business […], New accounting requirements […], Regulatory requirements […], Current and prospective financing requirements […], Use of IT […], The effects of implementing a strategy, particularly any effects that will lead to new accounting requirements […]'

Constructing a research model on critical accounting policy choices should thereby take into account the assessment of temporary external audit influences on management estimates.

4. CONCLUSION

This paper argues firms' management inability to apply accounting standard-setters' recommendations relating to uncertainties. Accounting conservatism is proposed to be a key measure for financial reporting quality.

Among seven mapped conservatism measures, it is concluded that accounting policy choices could be taken for constructing dependent variable as it is a 'cause-effect accounting' method explaining firms' reaction to uncertainties and prediction of future cash flows. Recently revised IAS 1 introducing fair value of all assets and liabilities based on expected cash in- and outflows for same (level 1) or similar (level 2) positions adds on to our assumptions. Critical accounting policy choices determining process of estimates and their implications in financial reporting are taken as central navigating tool of internal control system. Assumptions based on relevant facts, such as high illiquidity, slow and uncertain court cases, and weak consumption measurement, were used in proposing set of relevant accounting policies. We argued that inherent risk is rather low and auditors' opinion is affected to great extent throughout assessment of management estimates.

Based on research conclusions, we consider as necessity an issuance of guidance in term of creating critical accounting policies and aligning those to firm's annual report, i.e. list of declaratively recognized risks disclosed therein.

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[i] International Standard on Assurance Engagements (ISAE) 3400, "The Examination of Prospective Financial Information" (Previously ISA 810), issued by International Federation of Accountants (IFAC) effective for audits of financial statements for periods beginning on or after December 15, 2009

[ii] International Standard on Auditing 315: "Identifying and assessing the risks of material misstatement through understanding the entity and its environment" issued by International Federation of Accountants (IFAC) effective for audits of financial statements for periods beginning on or after December 15, 2009