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Insights into the Accounting Conservatism Literature: A Selective Criteria Analyzing

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Abstract- This study attempts to present a literature review for accounting conservatism that is considered one as of the most ancient and debatable terms in accounting research. Based on several academic studies the theoretical background propose an examination for accounting conservatism which consists of definition, explanations for existence raisons of accounting conservatism and gives measurement models in order to provide a better insight. It is also contribute on the growing literature investigating the role of conditional conservatism in the value of equity markets. Starting from the idea that the conditional accounting conservatism is characterized by an asymmetric recognition of positive and negative economic news we present respectively some sources of conditional accounting conservatism; the goodwill impairment, long-lived asset impairment, inventory recorded at the lower of cost or market and asymmetry in gain/loss contingencies.

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Insights into the Accounting Conservatism Literature: A Selective Criteria Analyzing

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Abstract- This study attempts to present a literature review for accounting conservatism that is considered one as of the most ancient and debatable terms in accounting research. Based on several academic studies the theoretical background propose an examination for accounting conservatism which consists of definition, explanations for existence raisons of accounting conservatism and gives measurement models in order to provide a better insight. It is also contribute on the growing literature investigating the role of conditional conservatism in the value of equity markets. Starting from the idea that the conditional accounting conservatism is characterized by an asymmetric recognition of positive and negative economic news we present respectively some sources of conditional accounting conservatism; the goodwill impairment, long-lived asset impairment, inventory recorded at the lower of cost or market and asymmetry in gain/loss contingencies.

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I. Introduction

This essay provides a selective explanation and discussion review of the accounting conservatism literature focusing primarily but not exclusively on theoretical research. Selectivity is necessary given the many topics that comprise accounting conservatism research. Specifically it aims to present some definition and measurement of accounting conservatism illustrated from the most important papers treated the explanations of conservatism accounting phenomena. This paper present a theoretical discussion and analysis of the themes treated in some of the most important papers on accounting conservatism topic. Going through several studies, we note that some papers discuss conceptual debates supported by methods of determination and measurement of accounting conservatism, others papers proposes just purely theoretical discussion of accounting conservatism topic, and the most of papers present measurement of accounting conservatism.

The conservatism area, one of the most prominent characteristics of financial accounting information, has influenced accounting practices for centuries. It can be alternatively defined as the asymmetric recognition of economic losses versus gains such presented by (Basu, 1997) or it can be identify us the understatement of book values independent of economic gains and losses like that defined by Beaver & Ryan, (2005). These two interpretations of accounting conservatism are referred to their sources as a conditional and an unconditional accounting conservatism Beaver & Ryan, (2005). Indeed, the unconditional conservatism it comes from some practices related to the over-expensing, early expensing, and deferring revenue recognition and it can impounds a negative persistent in the process of bias in book values, contrarily only conditional accounting conservatism arises from efficient contracting needs to protect the interests of stakeholders.

Accounting conservatism was defined as a downward bias in the accounting net asset value relative to the economic net asset value arising from an incomplete and inconsistent recognition of economic value in accounting earnings. It has been considered as an important accounting principle for centuries such firstly presented by Basu, 1997. Similarly, Watts (2003a, b) propose more explanation to this phenomenon which provides that the demand for conservatism results from the contracting role of accounting. Mostly, there are two important reporting features of conservative accounting are asymmetric timeliness in recognition of accounting gains versus losses which qualify in the conditional conservatism and systematic understatement of net assets value which characterized as unconditional accounting conservatism such as presented in several research Givoly et al., 2007; Roychowdhury & Watts, 2007. Watts, (2003a) point out that these two features are related to accountants' predisposition to require a higher degree of verification and certainty for the establishment of assets as compared with liabilities.

In what follows, Section 2 presents a literature and background on accounting conservatism. Section 3 focuses on the accounting conservatism measurement. Section 4 comments on the conditional conservatism sources. Section 5 briefly concludes.

II. Literature and Background on Accounting Conservatism

Hence, Kothari et al., 2009 argues that the managers have incentives to delay disclosure and recognize the bad news due to their career and compensation concerns, therefore a conditional conservatism could be more beneficial to the concerned' shareholders with losses and are less

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informed about impending bad news. Because accounting conservatism forces earlier recognition of economic bad news the value stock price value in the case of a conservative firm is likely to be closer to its fundamental value than those in the case non-conservative firm. The information announced by the less conservative firms' in the financial statements is more likely to be provided in the upper end of the distribution of fundamental values of the firms. The information disclosed by conservative firms will be perceived by the market as less biased and more accurate, while the information delivered to the market by less conservative firms could be perceived as more optimistically biased.

As a finding, when a bad news is disclosed, for less the conservative companies, the market is concerned that the revelation of bad news announced is not complete, and it might react more stronger. Conversely, the market can react to good earnings news in the case less conservative firms will be more subdued than the good earnings news announced by more conservative firms. Kothari et al. (2009) argues that the market reacts particularly negatively to the announced news of dividend decreases. The authors discuss this result as recognizing that managers are more likely to withhold bad news disclosed relating to dividend cuts. Moreover, it is interesting to provide whether a greater conservatism constrains the managers' in the behaviorism earnings management and forces bad dividend news ‘‘out” earlier.

A several research developed to propose measures of conservatism, chiefly those of the Basu, 1997 asymmetric timeliness measure being the most prominent. Hence, the Basu model based on the question how economic income, as evaluated by market returns, is asymmetrically related to the accounting earnings. By examining the effect of earnings on stock returns, Basu provides his predict assumption that the coefficient of stock returns will be higher when companies have ‘‘bad news” than when the companies have ‘‘good news”. Moreover, Basu conclude that also the litigation climate can affects the degree of conservatism. Other stud such those of Givoly and Hayn, 2000 and Holthausen and Watts, 2001 analyze the variation in earnings conservatism over time. Ball et al., 2003, and Bushman and Piotroski, 2006 make comparison between international contexts about the degree of conservatism across some different accounting systems. Other research tests whether conservatism is associated to ownership structure and whether conservatism participates to reduce the information asymmetry. Ahmed and Duellman, 2007 provide that the conservative accounting is practiced to assist board directors to reduce agency costs of the company.

More specifically, their results present evidence that the presence of inside (outside) directors is negatively (positively) related to the accounting conservatism. In another study and Focuses on managerial ownership, LaFond and Roychowdhury, 2008 show that the severity of agency problems increases, leading to a greater demand for the accounting conservatism level. Also, their results provide that the accounting conservatism directly declines with the level of managerial ownership, and hence provide evidence of a demand for conservatism from the firm's shareholders. Besides, after controlling for the other demands for conservatism, LaFond and Watts, 2008 find that conservatism reduces information asymmetry. They conclude that information asymmetry between the inside and the outside equity investors make a demand for accounting conservatism in the financial statements. All forms of accounting conservatism recognize by an understatement of accounting book value related to the market value of equity. Additionally, the accounting conservatism will generally recognize in understated assets and revenues, overstated liabilities and expenses.

III. Accounting Conservatism Measures

To measure the conditional conservatism, Basu (1997) propose his model by based on how the economic income, measured by market returns, is asymmetrically correlated to the accounting earnings. He also provides that the litigation climate affects the degree of conditional conservatism. Since the publication of Basu's paper on 1997, several studies have begun to pay attention to the incremental coefficient of negative returns as the asymmetric timeliness coefficient that is, the measure of conservatism in accounting area. To explain the validity of this model, Beaver and Ryan (2005), and Ball, Kothari and Nikolaev (2009) analyze the econometrics of the Basu's asymmetric timeliness coefficient through a model in which stock prices lead accounting earnings.

There are two important reporting criteria of conservative accounting; the asymmetric timeliness in recognition of accounting gains versus losses and the systematic understatement of net assets (Roychowdhury and Watts, 2007; Givoly et al., 2007). From the accountants' predisposition these two criteria require a high degree of verification and certainty for the establishment of firm assets as compared with liabilities such as argued by Watts (2003a). The most important criteria of conditional accounting conservatism is characterized by the needing of a lower verification requirements of accounting recognition based economic losses as opposed to economic gain. Thus, conditional conservatism characteristics can forces the managers to reveal their private information about negative economic shocks in a more timely fashion.

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a) Market-to-book

In some framework, the accounting information reports the value of separable net assets that can be independently liquidated from other components not the contemporaneous market value of equity. The contracts written on accounting disclosed information require that information must verify two criteria the timeliness and verifiability. The asymmetric information is considered as a nature criterion of the payoffs between various contracting parties introduces asymmetric verification standards for gains versus losses. But that can causes some unverifiable increases in the amount of separable net assets and that not labeled.

Empirical study has tended to identify the accounting conservatism as the understatement of the market value of equity, or changes therein. This is a common feature of almost all empirical measurement of accounting conservatism, including the Basu model. Indeed, the Market value of equity (MVE) incorporates not just separable net asset values, but also it includes the rents on the current projects and some future growth opportunities. The use of MVE can be argued by the belief that accountants can supply with verifiable or reliable estimates of the firm' equity market value and that are better than the observed market value in liquid markets, and it's possibly due from a lack of a framework for accounting conservatism literature.

There are a several alternatives of the non-equity market-value-based conservatism measures have been used occasionally, e.g. the Basu model 1997 uses the earnings reversals while Givoly and Hayn (2000) include the sign and magnitude of accumulated accruals. There are different aspects of accounting conservatism that can be included in the presentation of various measures such the market-to-book (MTB) haw the extent to which the book value of net assets can understates the market value of equity . Dechow et al. (2010) propose an analyzing study aims to explain how earnings quality is defined in the accounting literature and the proxies commonly used to measure it. The authors find that there is no consensus definition of earnings quality, which may be attributed to the different perspectives on the use of accounting information

b) The Basu asymmetric timeliness measure

Basu 197 examines the extent to which a given period's "good news" or "bad news" about a firm is incorporated in the firm's earnings. Basu (1997) uses include the stock returns as a proxy for news measurement. Indeed, the stock prices reflect the market' information which receives from a variety of sources other than current earnings and hence the firm' stock price changes are a measure of news arrival covering a concerning period. The Basu model is based on an expectation of asymmetric standards for the verification of losses and gains to make a bad news (e.g. negative stock returns) and that can be reflected in current earnings more than good news (positive stock returns.

Although there is a plentiful study on accounting conservatism, the lack of a firm-year measure of conservatism in prior developing literature once limited the kinds of assumptions examining that could be conducted. Using the estimation C_Score, based on the Basu (1997) asymmetric earnings timeliness notion, and other variables affecting conservatism such the size, the market-to-book or the leverage implied by accounting conservatism, Basu, 1997 and, Khan and Watts, 2007, find that firms characterized by a longer investment cycles, the younger firms of firms with higher idiosyncratic uncertainty are more conservative. They justify these results by referring to firm characteristics, firstly, the younger firms are less mature and less stable, and therefore they will have more information asymmetry problems. Secondly the firms with a longer investment cycles tend to have less verifiable earnings, to be more likely to face adverse outcomes from investments, and to expose their shareholders to losses. Thirdly, the firms with higher idiosyncratic uncertainties (as measured by the standard deviation of daily stock returns) have a higher degree of conservative accounting because agency costs increase with idiosyncratic risks. Therefore, for these different raisons these firms have a greater contracting demand for accounting conservatism level.

The framework for accounting conservatism of Roychowdhury and Watts (2007) purpose to generate and examine the effect of new predictions on the relationship between market-to-book and asymmetric timeliness varies with measurement horizon. Using their framework, Roychowdhury and Watts (2007) predict and provide positive relationship over long horizons related market-to-book end of the period to asymmetric timeliness. The authors find that positive returns accompanied by high value of ending market-to-book ratios can be reflected by an increasing in rents values or in unverifiable separable net asset values. The framework used by Roychowdhury and Watts (2007) is can be used to make their predict assumptions about the relation between the market-to book of end period and the asymmetric timeliness, finding the predicted results does not provide conclusive evidence that their framework necessarily explains accounting practice.

Roychowdhury and Watts (2007) include a framework based on the idea that ''the role of accounting is to report the market value of net assets available for interim distributions to claimants'' to make tow assumption related to estimation period, firstly, the previously-documented negative association between asymmetric timeliness and market-to-book ratio and to predict a positive association related asymmetric timeliness and the ending market-to-book ratio. Their discussion provides findings consistent with their framework, suggesting that previous studies criticizing

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the asymmetric timeliness measurement merely caused by the negative correlation with market-to-book is likely misguided.

IV. Conditional Conservatism Sources

Extending different definitions of accounting conservatism, accounting researchers have categorized the aforementioned understatement of accounting value on two broad forms of conservatism: conditional conservatism, and unconditional conservatism. The most important difference between the two forms of accounting conservatism is that the application of conditional conservatism is specifically based on economic news events, but the application of unconditional conservatism does not need it. The accounting Conditional conservatism produced when the accounting disclosure is based on economic' bad news on a timelier basis more than with economic good news. In short, the conditional accounting conservatism is characterized by an asymmetric recognition of positive and negative economic news. The conditional accounting conservatism depends on asymmetric information about the treatment of loss and gain contingencies and accounting for inventory using the lower-of-cost-or-market convention practices.

However, the unconditional conservatism occurs through the consistent under-recognition of accounting net assets. In contrast to the conditional conservatism, the unconditional conservatism practices does not related to news events. The unconditional conservatism characterized by some practices such as an immediately expensing research, accelerated depreciation or the development expenditures. While conditional and unconditional conservatism both result in a downward bias in accounting value, these two forms of conservatism arrive at this bias through different accounting practices. Moreover, accounting studies has made a point to distinguish these two forms of conservatism from one another.

Beaver & Ryan, 2005 provide that Conditional conservatism differs from unconditional conservatism in that it is news dependent. In other words, book values are written down under sufficiently adverse circumstances but not written up under favorable circumstances. In addition, Ball and Shivakumar (2005) provide that conditional conservatism can improve contracting efficiency, while unconditional conservatism seems inefficient or at best neutral in contracting.

a) *Goodwill impairment*

Holthausen & Watts, 2001 consider that the goodwill is not separable from the firm, and thus declines rapidly in net assets value when a firm is in financial distress to become a worthless in the event of firm liquidation. Hence, this explanation is consistent with the accounting conservative disposition often the observed around debt contract monitoring since the event of debt contracts are designed to protect the interests of those lenders concerns about losses at the liquidation process. Further, the evaluating and reporting of goodwill by the accounting standards guide might not yield net assets values that lenders view as reliable. The Managers use subjective estimating method in the measurement of goodwill. Watts (2006) argue that this subjectivity provides the opportunity to manipulate the reported value of goodwill to the lenders' detriment.

Based on the SFAS No. 142, the tests of goodwill impairment are referring to the fair value estimates that are largely at managements' discretion. Furthermore, the goodwill is not an asset that can be sold separately from the other assets of the firm. However, the lenders who are particularly related to the solvency and liquidity risks are likely to discount or even ignore the value of recorded goodwill.

Several recent researches investigating on different contractual terms and argue that private lenders do contract on goodwill. Also, other studies find evidence that when the goodwill and other intangible assets include a high part of the total assets, and it is can be more likely that if these assets are added to the net worth. This result suggests that lenders do consider entirely the information announced in goodwill values when goodwill is significant in amount and therefore, a more important asset on the balance sheet. Watts (2006) find that the conservative estimate models are needed and thus intangible assets must be excluded from the calculation of net assets in private contracting purposes. The findings are consistent with those of other studies for e.g. Leftwich (1983) argues that the managers benefit from their discretion and estimates inherent in SFAS No. 142 to avoid goodwill impairments, thus rendering the earnings to be less representationally faithful.

Also, Watts (2006) find that estimating measurement of goodwill is typically not verifiable since the periodic estimation requires the value of the firm that is frequently not verifiable, and that allows for significant manipulation. Similarly, Frankel et al. (2008) find some evidence that net worth covenants still tend to exclude intangible assets following the adoption of SFAS Nos. 141 and 142. Other paper reports a qualitative testing of financial accounting in the area of goodwill impairment. Specifically, they discuss the calculative practice involved in the producing of goodwill impairment values that are recognisable and impersonal enough to pass the test of reliability.

b) *Long-lived asset impairment*

Under the U.S. GAAP, the firms from the oil industry start to use either of two oil and gas accounting methods, full cost or successful efforts. Under the integration of successful efforts, only those exploration costs relating to successful wells are recorded as

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assets. All exploration costs for unsuccessful wells, or &dry holes,' are expensed. By contrast, the exploration of costs related to both dry and successful wells are capitalized under full cost. While, although full-cost companies can record dry holes as net assets such as required by the U.S. Securities and Exchange Commission who recommend them to proceed a quarterly impairment test, recognize by the 'ceiling test', on the capitalized net assets value of oil and gas firms.

The findings of empirical study of Alciatore et al., (2000) conducted in the oil and gas firms, show that the oil and gas firms' referring that they take the write-downs would have an "unrealistic and harmful" impact on net value of firms' equity was not justified since the returns that are associated with the write- down amounts realized in the quarters prior to and contemporaneous with the quarter in which the write-down is taken.

c) Inventory recorded at the lower of cost or market

Our study also carries theoretical implications for researchers. Indeed, the Inventory record inaccuracy (IRI) was severally considered as a pervasive question needing theoretical explanation and empirical investigation in retailing and causes non-trivial profit loss. The simulation models used to evaluate the effect of random errors on not only inventory record inaccuracy but also it can include the lost sales. The most results support the necessity to infer erroneous inventory records and incorporate statistical estimates into inventory control (DeHoratius et al., 2008; Mersereau, 2013; Chuang & Rogelio, 2015). Other study provide that the Inventory record inaccuracy can refers to the discrepancy between physical and recorded inventory levels, and is a pervasive problem in retailing; for e.g. in their Kok and Shang (2014) conclude that the conclude that IRI can be attributed to shrinkage, transaction errors, and misplacement.

d) Asymmetry in gain/loss contingencies

A lengthy literature addressed to the sources of conditional conservatism has given rise to numerous corollaries, including asymmetrical utility drawn from asymmetry in gain/loss contingencies, non-linear probability evaluations of gains and losses, an asymmetrical decreasing sensitivity and an endowment effects to the status quo-condition.

The findings of several studies show evidence to improve the model fit along with large impacts for welfare measurement when referencing is accounted for. However, previous empirical tests of reference-dependent behavior assumed left a series of unresolved topics. Firstly, there is only a few of evidence that argues the explanation on how referencing influences different attributes and whether other reference points and which provides that matter apart from currently experienced levels. secondly, in transportation situation, the reference-dependence is can be typically examined only for travel time and fare and has rarely been explored in cases of complex trade-offs referring to several attributes, a typical criteria of real world choices.

Recent research such those of Horowitz and McConnell, (2002) and Bateman et al., 2008) provide that, in some situations, the numeric information which are contrasted with an alternative treatment in which objectively identical accounting information is announced in visual form via virtual reality of the same data. In similar cases, the authors consider the reliance upon the numeric information exacerbates tendencies for survey respondents to rely upon heuristics rather than their underlying preferences in formulating responses. Using such insights to the field of non-market valuation, for certain environmental goods, information on increases or decreases in the numeric levels of an attributes may trigger reliance upon the loss aversion heuristic, leading to an exacerbation of the well know gains/loss asymmetry problem.

V. Conclusion

Accounting conservatism is severally discussed in the accounting literature research, indeed its definitions sometimes complement each other, and sometimes ideas are resumed under different expressions. Between different measures of accounting conservatism, it seems obvious the method starting by Basu's model although as we have seen, some researchers canceled this method such Richard et al., 2006 and others researcher limited to present its limitations (Givoly et al., 2006).

This study tend to give a selective critical review of the financial accounting literature focusing on one most prominent characteristic of financial accounting information research topics: accounting conservatism identification, measurement and the conditional conservatism sources.

Sometimes, accounting researchers have followed paths that although they have been proved viable in their research, but they have not been argued by some economic reality, thing which signaled by other researchers who propose subsequently to resume the respective topics. Whereas afterwards, such several researchers began their work based on the definition and methods of determination of accounting conservatism developed by Basu 1997, we consider that this contribution was analytical for accounting conservatism research. Whereas in this field the accounting literature is vast, our review has not exhausted the topic of its revisal, as we didn't propose to do this in these few pages.

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