



ACCOUNTING CONSERVATISM: A LITERATURE REVIEW

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ARTICLE INFO	ABSTRACT
<p>DOI: 10.52932/jfm.v3i1e.613</p> <p><i>Received:</i> September 14, 2024</p> <p><i>Accepted:</i> March 04, 2025</p> <p><i>Published:</i> March 25, 2025</p> <p>Keywords: Accounting conservatism, Measurement method, The role of accounting conservatism.</p> <p>JEL codes: M40, M41</p>	<p>Accounting conservatism reduces information imbalances in the accounting information system between people within the unit and information users outside the unit, reducing the ability to manage key custom reporting accounts (LaFond & Watts, 2008) and is a key determinant of financial reporting quality (DeFond & Zhang, 2014). Meanwhile, globalization and the internationalization of capital markets require very high transparency, timely response to financial reports, and the quality of main financial reports. Therefore, this study was conducted to provide an overview of prudential accounting in terms of definition, classification of prudential accounting, measurement methods, and important factors affecting prudential accounting. The results of this study have provided the most general theoretical foundation for prudential accounting, which is the basis for future research on this issue and at the same time provides a theoretical foundation to support readers gaining a comprehensive view of prudential accounting as well as its role in financial reporting quality to build appropriate research directions in the future.</p>

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1. Introduction

Accounting conservatism has been studied for decades and has grown significantly over the years and findings show that accounting conservatism is of interest in many markets (Ball et al., 2003; Basu, 1997). Accounting conservatism is one of the important characteristics of accounting information in financial statements (Neag & Masca, 2015; Sterling, 1970). Accounting standards often include the principle of conservatism, and it plays an important role in financial reporting but in 2010, the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) proposed to remove it from the common conceptual framework. Because FASB believes that accounting conservatism distorts accounting information and compromises neutrality (FASB, 2010). In agreement with that view, some researchers also acknowledge that accounting conservatism biases the numbers in financial statements, leading to ineffective decision-making (Gigler et al., 2009; Guay & Verrecchia, 2006). Meanwhile, some other studies argue that accounting conservatism arises naturally between the parties to the contract and is necessary as a mechanism for the contract to be effective (Watts, 2003; Basu, 1997). This means that in a loan contract, there are repayment terms that are not suitable for the lender, for example, when the debtor's financial situation is good, it does not increase the benefit for the lender, but the debtor's financial situation is weak, it will increase the risk of default and affect the ability to recover the debt for the lender. Therefore, lenders require borrowers to report information related to poor financial performance (bad news) in a timelier manner than information reflecting good financial performance (good news) (Basu, 1997). Furthermore, accounting conservatism encompasses various aspects such as earnings quality, predictability, sustainability,

persistence, and timeliness (Krismiaji & Sururi, 2021). Accounting conservatism reduces agency problems, reduces information asymmetry (Francis et al., 2013; Lafond & Watts, 2008), and accounting conservatism is especially important in valuation, especially during times of economic uncertainty and stress (Nur et al., 2023). These opposing views have led to debates on the role of accounting conservatism (Ruch & Taylor, 2015). The function of accounting is to capture information to assess the market value of equity and make investment decisions. On the other hand, the main function of accounting is to provide information to calculate the efficiency of contracts as well as to evaluate the benefits of accounting conservatism depending on the perspective of accounting information. Therefore, from those controversial issues, many studies have been conducted to assess the importance of accounting conservatism as well as to create a foundation for future studies on accounting conservatism (Zhong & Li, 2017; Ruch & Taylor, 2015; Neag & Maşca, 2015).

The concept of accounting conservatism is highly relevant in the context of developing countries where corporate governance is not yet effective but plays an important role in the application of the principle of accounting conservatism (Song, 2015). However, cases of fraudulent misrepresentation of financial statements such as the case of two companies that caused a stir in Vietnam, JVC and Cuu Long Pharmaceutical, illustrate the incomplete compliance with the principle of conservatism in accounting. JVC manipulated financial statements by changing accounting policies with easier, more positive revenue recognition and slower cost stretching; transactions with related parties increased. Cuu Long Pharmaceutical also affected financial statements through revolving transactions between parties to create fictitious revenue and price manipulation for the public offering of shares. Such actions harm investors and undermine the integrity of the capital

market. Therefore, strict supervision and strict enforcement of laws are required to prevent and ensure the reliability of corporate financial information. Dechow et al. (2010) stated that accounting quality is an important source of information for decision-making, more accurately representing the performance of the entity, so practicing prudence in accounting is important to ensure the reliability and utility of financial information provided to stakeholders.

Therefore, in this study, the author, through reviewing articles published in prestigious journals related to accounting conservatism, evaluates accounting conservatism from three aspects: (1) *What is accounting conservatism and how to measure it*; (2) *Perspective on accounting conservatism* and (3) *Role of accounting conservatism for users of information in financial statements*.

2. Literature review

2.1. Definition of accounting conservatism

Accounting conservatism has attracted the attention of various scholars with the main point being to describe a reporting situation in which early recognition of bad news is preferred over good news. First, Bliss (1924) defined accounting conservatism as anticipating no profits but anticipating all losses. Following this view, Devine (1963) defined accounting conservatism as a rule that leads to lower average expectations of goal achievement when compared to alternative measurement and reporting rules. Watts & Zimmerman (1986) and Belkaoui (1985) defined accounting conservatism as a situation of underreporting assets and revenues, and overreporting liabilities and expenses. Meanwhile, Feltham and Ohlson (1995) stated that accounting conservatism involves underestimating book values. In 1997, Basu (1997) proposed a new definition and measurement model with the implication of accounting conservatism to

capture the tendency of accountants to require a higher level of verification to recognize good news than bad news in financial statements. This means that accounting conservatism requires reporting bad news quickly as losses in financial statements, delaying the recognition of good news as profits (Hejranijamil et al., 2020).

Meanwhile, according to FASB and IASB, the principle of conservatism should be used cautiously by not facilitating the intentional understatement of assets, income, or intentional overstatement of liabilities, and expenses (IASB, 2008). FASB requires financial reporting entities to comply with high financial reporting regulations and accounting conservatism is an obstacle because this principle affects value. Although accounting conservatism is considered less related to value, its benefits in an era when data on financial statements are manipulated (Soyemi et al., 2020) should be considered a corporate culture of every organization. Sun and Liu (2011) argue that accounting conservatism has the potential to reduce agency problems and increase contract efficiency. Furthermore, accounting conservatism is a tax shield (Al Jaloudi, 2018; Hendriksen, 1982). Thus, there are many views on accounting conservatism, but the above definitions still include the issue that accounting conservatism is a guideline for recording information under uncertain conditions, using estimates carefully and reliably to record information. In Vietnam, according to the general standard VAS 01, accounting conservatism is one of the seven basic accounting principles, which is the consideration, deliberation, and judgment necessary to make accounting estimates under uncertain conditions. According to the above principle, Vietnamese accounting standards and circulars guiding the accounting regime also specify such things as not recording assets when future economic benefits are uncertain (research & development costs), recording liabilities and expenses that are likely to occur

(provisions for payables, accruals for expenses), recording decreases in asset value (establishing provisions for asset impairment). Meanwhile, the 2018 conceptual framework (IASB, 2018) explains that conservatism is the work performed when making judgments under uncertain conditions; not allowing accountants to overestimate or underestimate the value of assets, liabilities, income, or expenses.

2.2. Classification of accounting conservatism

Due to the confusion between conditional accounting conservatism and unconditional accounting conservatism, it has caused much controversy in accounting although it has an impact on accounting activities (Ball & Shivakumar, 2006). Some studies on the types of accounting conservatism (Chandra, 2011; Beaver & Ryan, 2005; Beekes et al., 2004; Basu, 1997). Accounting conservatism is divided into conditional and unconditional (Beaver & Ryan, 2005). Unconditional accounting conservatism occurs through incomplete continuous recognition of accounting net assets or unconditional accounting conservatism is not dependent on news while conditional accounting conservatism is dependent on news meaning conditional accounting conservatism occurs when negative news is recorded in accounting income in a timelier manner than positive news. Both types of accounting conservatism result in the book value of net assets being recorded being lower than their actual market value (Kabir & Laswad, 2014). However, it is important to distinguish between conditional accounting conservatism and unconditional accounting conservatism because: (1) They have different impacts on financial statements, for example, when applying an accounting policy consistent with unconditional accounting conservatism, it may have a consistent impact on the income statement from period to period, but the application of conditional accounting conservatism is only

temporary in the income statement due to fluctuations in economic content and news between periods (Chen et al., 2014); (2) The conditions that lead to conditional accounting conservatism are different from unconditional (Qiang, 2007), for example, unconditional accounting conservatism arises in a context where contract and litigation costs are high, while conditional accounting conservatism arises in a context where litigation, regulatory, and tax costs are high; (3) The application of this accounting conservatism affects the application of other accounting conservatism. Beaver & Ryan (2005) argue that unconditional accounting conservatism creates laxity in accounting, which may prevent the application of conditional accounting prudence.

2.3. Fundamental theory when studying accounting conservatism

The concepts of accounting conservatism are founded on agency theory and stakeholder theory.

Agency theory suggests that due to the separation of ownership and management (Jensen & Meckling, 1976), conflicts of interest arise. Managers are required to act in the best interests of shareholders while managers are always inclined to pursue their own interests. Managers always apply accounting policies that increase profits to increase their compensation accordingly. According to the accounting conservatism perspective, owners always want managers to be cautious in recording income by applying accounting policies and estimates that delay the recognition of favorable economic results but must report negative economic results as quickly as possible. On the other hand, managers are always motivated to choose accounting policies that record the most favorable business results, so adhering to accounting conservatism requires managers to report negative news quickly and delay recording positive news, thereby reducing

information asymmetry. Agency theory suggests that accounting conservatism is an effective tool to reduce conflicts of interest, minimizing earnings management activities. Therefore, accounting conservatism is considered an effective corporate governance and monitoring tool to minimize opportunistic behavior by managers.

At the same time, the stakeholder theory directs all activities of managers and owners for the benefit of all stakeholders, not for the benefit of any individual or group of individuals. Therefore, the accounting conservatism applied affects the disclosed information, so enterprises are not allowed to report too optimistically the financial situation and business results of the enterprise.

2.4. Accounting conservatism measurement method

Various methods are used to measure accounting conservatism such as market to book, earnings, accrued expenses, and the relationship between accrued expenses/cash flow and earnings/share. Specifically, accounting conservatism is measured in two aspects: based on the balance sheet and based on the income statement.

Measured on the balance sheet

Models of Feltham and Ohlson (1995), and Beaver and Ryan (2000)

The method of measuring by the asymptotic difference between book value and market value (MTB). In which market value is the expected value and opportunity growth, book value tends to recognize the news with caution. When MTB is greater than 1, the financial statements are considered conservative, and the greater than 1, the more conservative. However, Beaver & Ryan (2000) argue that MTB can be distorted because MTB has two parts: *bias component* and *lag component*. The bias component is that book value is constantly higher (lower) than

market value so that MTB is constantly higher (lower) than 1. While lag indicates that profits (losses) are recorded in book value over time rather than recorded immediately so that MTB is temporarily lower (higher) than the average. Therefore, Beaver & Ryan (2000) argue that only the bias component is used to measure conservatism.

Measured based on income statement

Earnings measurement: Basu (1997) argues that accounting conservatism captures the accountants' tendency to recognize good news and bad news. According to this definition, losses are recorded promptly with low verification and are more likely to be recognized in the current period. Therefore, firms with negative earnings or negative earnings volatility in the current period are more likely to experience positive earnings in the next period. The prediction is tested through cross-sectional regression using formula (1) and the value of β_1 will be negative and statistically significant, then the financial statements are conservative.

$$\Delta X_{it}/P_{it-1} = \alpha_0 + \alpha_1 D + \beta_0 \Delta X_{it-1}/P_{it-2} + \beta_1 D \times \Delta X_{it-1}/P_{it-2} + \epsilon \quad (1)$$

Where,

X is earnings before extraordinary items

P is the market value of equity at the beginning of the fiscal year

D takes the value 1 if X is negative and takes the value 0 otherwise.

Because losses are recognized in time while profits are recognized gradually in the future, the difference between the income deviation and the cash flow deviation is used to measure accounting conservatism (Aier et al., 2014; Ahmed & Duellman, 2010; Beatty et al., 2008). At the same time, the income deviation or cash flow deviation is calculated by $E[(x-\mu)^3/\sigma^3]$, where μ and σ are the mean and standard deviation of income (cash flow) over the 5 years

of observation. When the income deviation is negative, the financial statements are conservative.

Accrual measurement

Givoly and Hayn (2000) model

Without accounting prudence, accruals will disappear, and net income will become cash flow over time. Income is usually recorded on an accrual basis, so the asymmetric timeliness of income affects the accrual. Givoly and Hayn (2000) argue that when accounting conservatism is applied, it delays the recognition of economic benefits and accelerates the recognition of losses. This process carried out over a long period of time, will result in the total cumulative value of non-operating accruals becoming larger and larger and becoming negative. The trend of increasing total accrual value increases the practice of accounting prudence. The formula is:

$$NA = TA - OA (*)$$

Where:

NA is cumulative value of non-operating accruals

TA is the total accruals (TA= NI + DEP – OCF; with NI: income after tax; DEP is the depreciation charge for the year; CFO is the operating cash flow, and TA is the total assets)

OA is cumulative value of operating accruals

OA = Δ Receivable + Δ Inventory + Δ Prepaid expenses - Δ Liabilities - Δ Tax payable.

Givoly and Hayn (2000) find that the widespread and significant accumulation of negative non-operating accruals is consistent with increased accounting conservatism.

Ahmed and Duellman (2007) model

According to this model, Ahmed and Duellman (2007) measure accounting conservatism based on the Givoly & Hayn (2000) model but do not use non-operating

accruals but use total accrual accounting value to measure accounting conservatism. Specifically:

$$CONACC_{it} = \frac{A_{i,t-1} + A_{i,t} + A_{i,t+1}}{3} X(-1)$$

Where: $A = (EBEX_{it} + DEP - OCF)/TA$

A is the total accrual

EBEX is the earnings before tax and extraordinary items.

DEP is the depreciation charge for the year

OCF is the operating cash flow, and TA is the total assets

The value calculated from the above formula will give the opposite value compared to the Givoly and Hayn (2000) model, but in essence, both use accruals to measure accounting conservatism. With the view that the total value of accruals tends to decrease in value over the research period (Givoly & Hayn, 2000; Ahmed & Duellman, 2007) multiplied by (-1) to get a positive result for the purpose of conveniently assessing the results, meaning that the larger the CONACC value, the higher the level of accounting conservatism.

2.5. Parties' requirements for accounting conservatism

Watts (2003) proposes four explanations for accounting conservatism such as contracts, litigation, corporate income tax, and regulation involving the parties that require accounting conservatism respectively: creditors, shareholders, auditors, and regulators.

Creditor's Requirement for accounting conservatism: The separation of ownership and management rights leads to information asymmetry between creditors and managers, which creates an agency problem. Managers have an incentive to transfer assets from creditors to shareholders because of information advantages. Jensen and Meckling (1976) argue

that debt contracts evolved to alleviate the agency problem. Debt contracting protects the interests of debt holders by transferring control to them when the covenant is violated. Creditors prefer to recognize losses rather than profits in a timely manner because of asymmetric returns. But when the firm is in financial trouble, creditors will lose all their assets, so they demand timely loss recognition (Zhong & Li, 2017). Therefore, accounting conservatism has evolved to improve the efficiency of debt contracts by triggering covenant violations through timely loss recognition (Watts, 2003). Creditors can act to protect assets in a timely manner. At the same time, when profits are recognized with high accuracy, managers find it difficult to inflate earnings or profits, net assets, so creditors require accounting prudence. Therefore, there are quite a few empirical studies on the role of creditors in implementing accounting conservatism such as Ahmed et al. (2002) acknowledged that financial reporting is more conservative when the cost of debt is high; Zhang (2008) acknowledged that applying accounting conservatism benefits both creditors and debtors; Beatty et al. (2008) argued that creditors require more conservative reporting to reduce agency costs. Nikolaev (2010) argued that covenants used in debt contracts make financial reporting more conservative. Similar to that view, Tan (2013) found that accounting conservatism increases after the entity violates the covenants in debt contracts. Furthermore, Aier et al. (2014) acknowledge that creditors' demand for accounting conservatism leads to an increase in the level of accounting conservatism.

Shareholders' requirement for accounting conservatism

To mitigate the agency's problem of information asymmetry, executive compensation contracts are used. Managers tend to inflate earnings and delay recording

bad news for personal gain (Zhong & Li, 2017). Loss recovery is difficult for shareholders even with court judgments due to the limited liability of managers (Kothari et al., 2009; Watts, 2003), so accounting conservatism facilitates shareholders to mitigate the agency problem through timely recording of losses. It is also accounting conservatism that reduces the motivation of managers to implement projects with negative NPV due to the requirement to record losses promptly (Ball & Shivakumar, 2006). In addition, after paying interest, compensating managers, paying taxes, etc., the remaining assets belong to shareholders, so shareholders always want to reduce taxes. Accounting conservatism recognizes losses more promptly than profits, which can delay tax payments and increase firm value. Investors demand accounting conservatism because of information asymmetry (Lafond & Watts, 2008). The more severe the agency problem, the more accounting conservatism is required (Lafond & Roychowdhury, 2008).

Auditor's requirement for accounting conservatism

Auditors are responsible for the reliability and verifiability of financial statements and are subject to reputational damage and litigation when a company is found to have fraudulent financial reporting (Zhong & Li, 2017). Palmrose and Scholz (2000) acknowledge that auditors are more likely to lose litigation when financial statements are restated. Accounting conservatism increases during litigation against auditors (Holthausen & Watts, 2001; Basu, 1997) so auditors are required to increase accounting conservatism at the entity.

Regulatory's requirement for accounting conservatism

When a company faces bankruptcy, regulators tend to be criticized by the media and investors and may even be involved in

legal proceedings. For example, in the Enron incident, the SEC was heavily criticized by investors and had to enact the Sarbanes-Oxley Act to protect wealthy investors. Many empirical studies have shown that accounting conservatism is useful and indispensable for financial reporting (Ahmed & Duellman, 2010; Zhang, 2008; Watts, 2003), so this is inconsistent with the movement of regulators to eliminate conservatism (IASB removed the concept of accounting conservatism from the conceptual framework (IASB, 2008)).

3. The role of accounting conservatism to users of information on financial statements

Financial accounting information is relevant to users if it has predictive and confirmatory value (FASB, 2010), so this paper discusses the impact of accounting conservatism on users in the equity market, the debt market, and corporate governance. Equity market users may prefer relevant information from a valuation perspective, while debt market and corporate governance users may prefer relevant information from a contracting perspective.

3.1. For capital market users

Users in the capital market include investors and analysts (Ruch & Taylor, 2015). The impact of conservatism on investors and analysts through assessing the impact of accounting information quality on decision usefulness on two aspects: value and information asymmetry. Value refers to the extent to which accounting information has predictive or confirmatory value for decisions of users in the capital market, which is often related to accounting earnings and market value. According to Basu (1997), accounting conservatism is conditional on timely loss recognition, so it provides more relevant information, meaning a greater relationship between earnings and profits when bad news occurs. Collins et al. (1997) found that the decline in the value relevance of earnings

can be explained by the increase in accounting conservatism. Lev and Zarowin (1999) argue that the decline in value relevance for firms with increasing research and development costs.

The second aspect is information asymmetry. Accounting conservatism improves information quality if it reduces information asymmetry, but it will impair information quality if it exacerbates information asymmetry. Lafond and Watts (2008) acknowledge that accounting conservatism is positively related to information asymmetry and argue that capital market participants require accounting conservatism to minimize the impact of information asymmetry and therefore accounting conservatism arises when information asymmetry is present. Hui et al. (2009) also find a negative association between voluntary disclosure and accounting conservatism specifically that timely reporting of bad news acts as a substitute for voluntary disclosure. In addition, Francis et al. (2013) found that accounting conservatism reduces information asymmetry, which reduces the negative market reaction to bad news, and in their empirical study, they acknowledged that accounting conservatism positively affects stock returns during the financial crisis. Similar to the view of Francis et al. (2013), Kim et al. (2013) acknowledged the conditional accounting conservatism effect on the market reaction to seasoned stock offering announcements, which means that conditional accounting conservatism benefits investors by reducing the risk associated with information asymmetry. Therefore, accounting conservatism reduces information asymmetry and improves information quality.

3.2. For users in the debt market

To examine the impact of accounting conservatism on debt market participants (lenders and borrowers), this paper discusses the impact of accounting conservatism on information quality in debt contract settings.

The two most important components of information quality for debt market participants are the relevance of accounting information to lending decisions and information asymmetry. Only when accounting information is useful in assessing default risk is it of quality and reduces information asymmetry between borrowers and lenders (Ruch & Taylor, 2015). 200 agreements signed in debt contracts. Specifically, Watts (2003) hypothesizes that information about borrowers' losses is more relevant to lenders than information about borrowers' gains, and this hypothesis also suggests that accounting conservatism leads to lower interest rates for borrowers and lenders better assess borrowers' default risk. Ahmed et al. (2002) find that accounting conservatism reduces the conflict between bondholders and the cost of debt. Bondholders will accept lower interest rates if accounting conservatism can limit excessive dividend payments to shareholders. Zhang (2008) finds that accounting conservatism increases the ability to identify default risk and reduces interest rates. Meanwhile, conditional accounting conservatism reduces information asymmetry, increasing the efficiency of debt securities trading (Wittenberg-Moerman, 2008). At the same time, Setiadi et al. (2023), and Desyana (2022) argue that financially distressed firms adopt high accounting conservatism to avoid breach of contract and disputes between creditors and shareholders.

3.3. For corporate governance activities

Corporate governance is viewed as a mechanism by which shareholders monitor corporate management to reduce conflicts of interest among parties and reduce agency costs (Jensen & Meckling, 1976), and managerial compensation is a concern for corporate governance mechanisms. Accounting conservatism affecting managerial compensation can bring benefits to corporate governance: (1) Accounting conservatism

protects shareholders from overpaying managers. Watts (2003) argues that since accounting conservatism increases the likelihood of verifying reported information, using earnings to determine compensation can protect managers from overpaying based on profits. (2) Accounting conservatism is likely to encourage managers to make better investment decisions due to the timely recognition of losses (Louis et al., 2012; Francis & Martin, 2010). In addition, Ahmed and Duellman (2007) acknowledge that accounting conservatism positively affects the proportion of independent managerial ownership, thus increasing the independence of the board of directors, thereby reducing agency costs, and improving corporate governance. García Lara et al. (2009) argue that companies with strong corporate governance exhibit high accounting conservatism and Indarti et al. (2021) argue that the higher the managerial ownership, the higher the level of accounting conservatism. Accounting conservatism is used to minimize dividend policy conflicts between creditors and shareholders (Ahmed et al., 2002). Thus, accounting conservatism has a positive impact on increasing the efficiency of corporate governance.

4. Conclusion and future research directions

The article, through a review of studies in prestigious journals, has drawn definitions of accounting conservatism measurement methods, requirements of stakeholders as well as the role of accounting prudence for information users. At the same time, based on this assessment, it can be concluded that accounting prudence is an effective mechanism to minimize agency conflicts and information asymmetry. At the same time, accounting conservatism improves transparency, accountability, and usefulness of accounting information in decision-making. Even Sterling (1970) argued that accounting conservatism is the most influential valuation

principle in accounting. Studies acknowledge that stakeholders such as shareholders, creditors, auditors, regulators, and customers require accounting conservatism to reduce agency costs, reduce information asymmetry, and improve investment efficiency, and studies also acknowledge the impact of accounting conservatism on users in the capital market and debt market. Previous studies have suggested that accounting conservatism reduces the cost of debt capital, so future studies should consider whether the risk of loss when borrowers default is greater than the risk of loss due to profitable debt agreements. For stock market users, future studies can establish a theoretical link between information quality

and cost of equity, the accuracy of analysts' forecasts. In addition, studies also acknowledge that accounting conservatism has a negative impact on earnings quality, increasing earnings management, so future research can examine the relationship between unconditional accounting conservatism and real economic activity to achieve profit targets and can also study whether the use of inventory costing methods affects profits through overproduction? As such, we note several future research opportunities to provide additional information on the costs and benefits of accounting conservatism with the view that such research is necessary to fully understand accounting conservatism.

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