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Accounting conservatism: A review of the literature

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ABSTRACT

We review and analyze the accounting literature that examines the effects of accounting conservatism on financial statements and financial statement users. We begin by analyzing how conservatism affects the reported numbers on the financial statements. These studies primarily evaluate how conservatism affects earnings quality, including earnings persistence and the presence of earnings management. Next, we assess the effect of accounting conservatism on the users of the financial statements. We identify three primary users of the financial statements: (1) equity market users (2) debt market users and (3) corporate governance users. Within each of these categories, we analyze the findings of prior research and explore unanswered research questions. By analyzing the effects of accounting conservatism from a diverse range of research topics, we inform the discussion on the costs and benefits of accounting conservatism.

1. Introduction

Accounting conservatism can be defined as accounting policies or tendencies that result in the downward bias of accounting net asset value relative to economic net asset value. It is one of the most fundamental features of accounting information, dating back centuries (Basu, 1997; Watts, 2003a). While there is little question as to conservatism's existence, there is a debate among researchers and

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standard setters as to how costly or beneficial conservatism is to financial statement users. The Financial Accounting Standards Board (FASB) does not include conservatism as one of the qualitative characteristics of financial reporting in its conceptual framework because it believes that conservatism biases accounting information and compromises neutrality (FASB, 2010). Some researchers have echoed this notion, arguing that conservatism biases financial statement numbers to result in inefficient decision-making (Gigler, Kanodia, Sapra, & Venugopalan, 2009; Guay & Verrecchia, 2006).

Alternatively, some researchers contend that accounting conservatism arises naturally between contracting parties and is necessary as an efficient contracting mechanism (Basu, 1997; Watts, 2003a). This view stems from the idea that certain contracts (e.g., debt and executive compensation) have asymmetric payoffs to contracting parties, thereby resulting in timelier reporting of information that has the greatest potential to affect the contracting parties. For example, a debt agreement has asymmetric payoffs for the lender. While strong financial performance on the part of the debtor does not increase the payoff to the lender, weak financial performance on the part of the debtor increases the risk of default, thus reducing the lender's potential payoff. Consequently, the lending party demands that the borrowing party report information that may reflect weak financial performance (i.e., bad news) in a timelier manner than it would report information that may reflect strong financial performance (i.e., good news).

The controversy that fuels this debate arises from different perspectives on the informational roles of accounting. From one perspective, the primary function of accounting is to capture information that can be used to assess the market value of equity and make investment decisions ("valuation perspective"). From another perspective, the primary function of accounting is to provide information that allows contracting parties to evaluate the efficiency and effectiveness with which obligations are performed in contracting settings such as debt and executive compensation contracts ("contracting perspective").[1] Assessments of the costs and benefits of accounting conservatism are largely dependent on one's perspective on accounting information (i.e., valuation versus contracting), as information that is desirable from one perspective may be of little value from another perspective.

To address these issues, we review the literature and provide analysis of the effects of accounting conservatism. We discuss the effects of accounting conservatism in two phases. First, we discuss the direct effects of accounting conservatism on the financial statement numbers. Second, we discuss the effects of conservatively reported financial statements on the users of the financial statements. We analyze the effects of conservatism on three broad groups of financial statement users: (1) equity market users (2) debt market users (3) corporate governance users. The section on equity market users discusses how investors and analysts use the financial statements to make decisions about the firm. The section on debt market users discusses how lenders and borrowers use the financial statements in debt contracting settings. The section on corporate governance users discusses how conservatism impacts the effectiveness with which shareholders monitor firm management through executive compensation and investment decisions. Fig. 1 provides an illustration of the effects of accounting conservatism on the financial statements and the users of the financial statements.

We review 34 studies on the effects of accounting conservatism, the majority of which are published in prominent peer-reviewed accounting journals with dates ranging from 1997 to 2014.[2] Table 1, Panel A provides a count of the studies we review, grouped by source journal; Panel B provides a count of the studies we review, grouped by research topic. Overall, prior research has provided mixed evidence on the costs and benefits of accounting conservatism. Some of the studies reviewed in this paper find that conservatism alleviates information asymmetry, reduces debt cost of capital, makes executive compensation more sensitive to accounting earnings, and induces management to make more efficient investment decisions, all of which indicate that conservatism may be beneficial

[1] See Christensen and Demski (2003) for a complete discussion on the valuation and contracting roles of accounting information. Holthausen and Watts (2001), Barth et al. (2001), and Watts (2003a, 2003b) also discuss the dual roles of accounting information and how conservatism may or may not be useful in each of these roles.

[2] Our review includes a discussion of one working paper (Louis et al., 2014). We include a discussion of this study because its findings are particularly relevant to the effects of conservatism on analyst forecasts and are distinct from findings in published research. Additionally, Google Scholar indicates that this study has been cited 25 times as of January 2015.