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Understanding discretion in conservatism: An alternative viewpoint ☆

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ABSTRACT

Various studies have investigated variation in reporting conservatism with pre-specified contractual incentives. Lawrence et al. (forthcoming), hereafter LSS, propose a model to control for "normal" or "non-discretionary" conservatism while testing for variation in conservatism with contractual forces, which they characterize as "discretionary" variation. Our objective is to further the discussion on discretion in conservatism by relying on LSS and incorporating insights from related studies to shed light on the rationales and relative importance of various controls for normal conservatism suggested by LSS. Furthermore, our perspective on discretion in conservatism is distinct from the one developed by LSS in some crucial respects, ultimately leading us to question the nature of the boundary between discretionary and non-discretionary conservatism.

1. Introduction

An aspect of accounting choice that has received considerable attention in recent times is how conservatively a firm represents economic events on its financial statements. Various studies have investigated variation in reporting conservatism with pre-specified incentives, many and indeed most of which tend to be contractual in nature (for example, do explicit and/or implicit contracts with debt-holders and shareholders lead to greater conservatism in reporting?) This burgeoning academic literature on conservatism has, however, generally not explicitly discussed questions that arise in the context of the significant variation in conservatism that they document. First, should researchers expect firms to exhibit some normal level of conservatism? Second, if so, how does one estimate normal conservatism? Third, how much discretion do managers enjoy within the realm of Generally Accepted Accounting Principles (GAAP), and how does this influence normal conservatism? Fourth, does observed variation in conservatism reflect the norm or departure from the norm? Lawrence et al. (forthcoming), hereafter LSS, explicitly raise these questions and undertake empirical analyses in an attempt to answer them. Our objective is to further the discussion on discretion in conservatism by relying on the building blocks

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provided in LSS and also incorporating insights from other studies that have examined variation in conservatism and discretion in accounting choice.

GAAP provides standards for financial reporting that are considered binding and are enforceable; managers of firms reporting in contravention of GAAP can face substantial penalties and erosion of their human capital. Nevertheless, even within the largely rules-based approach towards financial standards inherent in U.S. GAAP, managers often enjoy substantial discretion in accounting choice.[1] On the one hand, the discretion is deemed necessary by standard-setters and regulators because it allows managers to decide upon the best financial-statements-representation of economic events affecting the firm; arguably managers are in the best position to assess these events and their impact. On the other hand, managers can conceivably exploit the discretion granted in GAAP to report in line with their own private incentives, which may not always align with the incentives of various stakeholders of the firm.

Managers' attempts to represent economic events accurately to the extent possible should lead to the development of some common elements, or norms, in the accounting choices of firms facing similar economic environments. Academics have attempted to identify such norms by developing models for predicting accruals based on revenues, assets, etc. (beginning with Jones, 1991) that are often estimated by industry. The predicted values from these models are generally referred to as normal or non-discretionary accruals, while the deviations are termed discretionary accruals. The attempt in LSS to model non-discretionary conservatism empirically is consistent with that approach.

Our viewpoints differ subtly from those of LSS, but those differences in totality amount to a perspective on discretion in conservatism that is very distinct from theirs in some crucial respects. We begin with a discussion of the sources of discretion in conservative accounting choices, as manifested primarily in the recognition of impairments in the values of recorded assets. Empirical patterns in the data generally point to managers enjoying substantial discretion in determining the timing and magnitude of asset write-downs.

Our discussion provides clues towards identifying the manner in which managers exercise their discretion. External parties, including academic researchers, do not observe the fair value estimates and estimation procedures that underlie managers' write-down decisions; this makes it difficult to assess whether the specific choices made by managers are accurate reflections of economic events, or driven by managerial opportunism. Researchers and other external stakeholders of firms such as auditors, investors and financial analysts, often address this issue by using market values at the firm level as a benchmark to assess whether book values are overstated, and write-downs are warranted. One approach is to measure the covariance between earnings and returns and allow that covariance to vary with the sign of returns; this approach underpins the Basu asymmetric timeliness measure. The ratio of market value of equity to book value of equity, or the book-to-market ratio, provides another alternative. When market value of equity is only slightly below book value of equity, particularly over a short horizon, it is possible that there is no immediate need to record write-downs that exceed the materiality thresholds for external reporting (see Heitzman et al., 2010). On the other hand, when market values remain depressed below book values over extended lengths of time, it is more likely that managers are exercising their discretion to avoid recording write-downs in an attempt to avoid their deleterious effects on earnings. Of particular interest in these cases is the role of auditors and other governance mechanisms that are supposed to constrain managers from reporting opportunistically.

LSS do not necessarily distinguish between discretionary reporting that reflects the economic environment (inclusive of contractual factors) and opportunistic reporting. Instead they propose a general model that controls for variation in non-discretionary or "normal" conservatism with the goal of identifying discretionary conservatism more accurately. Existing literature, particularly studies that rely on the Basu asymmetric timeliness of earnings to measure conservatism, already implicitly impose controls for normal conservatism; but the modifications proposed in LSS can certainly be viewed as attempts to minimize measurement and specification errors in existing models. Our interpretation of the evidence strongly suggests that of all the modifications proposed by LSS, the beginning-of-period BTM is most supported by economic intuition and also the only one that seems to significantly influence the empirical results. Note that BTM is also well-discussed in existing literature, with studies such as Roychowdhury and Watts (2007) already pointing to the necessity of controlling for it while examining variation in conservatism.

LSS view BTM, along with their other proposed refinements, as controlling for normal conservatism, while viewing variation in conservatism with contractual imperatives such as those arising from debt-holder and shareholder demands as manifestations of discretionary conservatism. We suggest important caveats with respect to this interpretation. An alternative interpretation of significant variation in conservatism after controlling for BTM is that the normal level of conservatism itself varies with underlying contractual forces. In other words, rather than motivating discretionary conservatism, contractual factors determine how the discretion granted in GAAP is "normally" exercised conditional on the economic environment. Moreover, if researchers are unable to detect a significant relation between hypothesized contractual factors (for example, the debt-related factors investigated in LSS) and conservatism after controlling for BTM, it would be hazardous to conclude that such contractual factors do not generate a demand for conservatism beyond what is required by GAAP. After all, contractual forces, for example those related to debt contracting, are very likely to have shaped the very evolution of conservatism in GAAP (see Watts and Zimmerman 1986; Watts, 2003).

[1] Accrual accounting routinely requires managers to make estimates (bad debts, obsolete inventory, pension liabilities, etc.), which by their very nature require managerial discretion.