Study of Factors Affecting Conservatism in Iran Financial Reporting

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Abstract

One important consequence of the conservatism asymmetric behavior is about the profits and losses and insistence on understatement net value of the assets. Legislators of capital markets, standards developers and academics, criticized conservatism for this reason: understatement in the current period may provide understatement cost of future periods and hence results overstatement earnings in future periods. According to Beaver (1998), conservative behavior is in such a way that leads to chosen lower revenues (revenues greater than) and more cost (than lower costs) and detects imposed losses.  
Conclusion: conservatism rather than a realistic assessment, thereby biasing the regular financial reports. As a result, the Financial Accounting Standards Board points out, «conservatism contradicts with important qualitative features, such as an honest, impartial and comparability (including consistency of procedure). In this paper, we attempt to examine the various factors that effect conservatism in financial reporting in Iran and to achieve acceptable results in the context to which we have referred.

Keywords: effective factors, conservatism, financial reporting (accounting).
Introduction:

Most research on issues related to the valuation of assets, in accordance with accounting principles refers to the definitions of Feltham & Ohlsons (Feltham & Ohlsons, 1995) on conservatism. They defined conservative accounting as «Expects that the net asset value reported by the company in the long term will be less than its market value.» In other word, it is assumed that the application of accounting conservatism and the reported market value of assets will be greater than the book value. According to the definition of the cost, identifying investment leads to create an expected positive net present value of the investment because analysts expect that these investments may be less than the estimated value.

Research conducted by Beaver and Ryan (Beaver & Ryan, 2000) has a similar view of accounting conservatism, that accounting conservatism is the difference between market value and book value of assets as well. Penman and Zhang (Zhang, 2002 & Penman) identified accounting conservatism as choosing method and estimating the accounting shows book value of the assets clearly low.

**Defining Conservatism**

Conservatism in accounting is defined by Bliss (1924) as "no forecast profit, but anticipate all losses." Forecast earnings mean to detect earnings before there is a legal claim to earnings that cause creation of them and revenues are being affected in earnings.

Accounting conservatism can be classified into three categories:

A - Behavioral categories: pessimism is better than optimism. For example, based on the accountant’s guidelines, potential liabilities (potential losses) are recognized under certain circumstances, if possible, the guidelines do not apply on assets (profit potential).

B) Time category: the earlier showing losses and costs are better than later showing income and later showing earnings is better than earlier.

C) The value category: understatement of income and earnings is better than overstatement and overstatement of losses and costs is better than understatement. Another definition that has been done by researchers from conservative accounting, stated that: conservative accounting is an accounting concept that leads to a decrease in reported retained earnings by the later recognition of revenue and faster recognition of cost, lower valuation of assets and higher valuation of debt.

**Conservatism position in the theoretical concepts of accounting**

Conservatism is proposed as a covenant. Conservative is considered as cautious response to the uncertainties. In 2006, the International Accounting Standards Board (IASB) and the America Financial Accounting Standards Board (FASB) published joint paper in the field of financial reporting framework.
According to the Joint Committee, the qualitative characteristics of financial reporting information, influencing decisions, consists of the following components.

1. The ability included, valued and certified to predict future cash flows.
2. The relevance included such prediction value and certified the future cash flow.
3. Comparability, including consistency
4. The ability to prove, completeness and fairness

Neutrality is a characteristic of a fair presentation of the financial information from the Joint Committee view. The other is the unwillingness to recognize it before events or incentive to make behaviors, especially in front of them. Joint Committee, in its discussion paper, has removed the qualitative characteristics of financial reporting. IASB in August 2007 provided fair value (definitions and how to measure fair value) in paragraph 9, and points out that accounting conservatism is one of the characteristics of qualitative characteristics of accounting information.

In our country (Iran), the Technical Committee of the audit, in the Appendix of Iran accounting standards is presented. In the theoretical concepts of reporting section, in other words, the cautious conservatism recognizes conservatism as one of the components of reliable quality characteristics.

**Conservative interpretations**

According to Watts (2003), the root of conservatism in financial reporting is economical. He states four factors in establishing it (Watts and Roychowdhury, 2006)

1. The contract between the company and those who are employed (including directors) and the contracts between the company and outside parties (the debt to the shareholders and other creditor) interpretation of conservatism contracts
2. Increase in the cost of lawsuits. (Lawsuits explanation of conservatism)
3- Views of regulators and modulators of accounting (such as the SEC and FASB) (Lawsuits explanation of conservatism)
4. The relationship between reported earnings and taxes. (Tax explanation of conservatism)

Conventional explanation refers to a conflict of interest between the parties with a profit organization. These contracts include manager’s contract and liabilities contract to shareholders and other creditor. Each of the parties pursues its interests. For example, shareholders tend to overstatement of income and assets; increase their wealth in the economic unit. Also managers tend to over statement of the financial performance, and as a reward, they increase their wealth. The moderator of accounting, expenses arising from overstatement revenues assets are more than interests (Watts, 2003a). In addition, the relationship between reported earnings and taxes can also create interest in identifying the different costs and revenues.
The importance of conservatism

Watts (2003) argues that conservatism in financial reporting is the result of economic reasons. His explanations are presented as four factors that include:
1. The conventional explanation
2. Lawsuits explanation
3. Tax explanations
4. Rules accounting explanation

A common feature of these economic factors is that in all these cases, an "asymmetric loss function" can be seen. For example, based on conventional explanation - shareholders due to their limited liability for agreement are asymmetric loss function. Therefore, they are motivated to the overstatement of profits and net assets, transfer wealth from debt holders to their own. Similarly, managers have limited liability and an incentive to the overstatement of the performance of the company and the transfer of wealth from shareholders to their own. Costs of legal proceedings are asymmetric; directors, auditors and firms are more likely to overstate profits and net assets than the understatement of the fact. Similarly, accounting legislators to overstatement of profits and net assets will cost more. Relationship between reported earnings and tax incentives defer revenue recognition and speed up the identification of costs and losses and decrease the present value of tax. (Vrychvdary and Watts, 2006, p. 10)

Common points between these four explanations suggest that they may be a manifestation of an explanation. (Watts, 2003, p. 210). The results indicate the importance of each interpretation

Conventional explanation

Conservatism caused the use of efficient technologies in the company resulting from contracts with various individuals and groups. According to this interpretation, conservative accounting came to show and point to various groups which have unequal and asymmetrical information, and unequal benefits, narrow intellectual horizons and limited liability. For example, conservatism can limit manager’s opportunistic behavior in reporting accounting indicators used in contracts.

Until the reporting of management performance, accounting criteria and indicators used there are always distorting problems in financial reporting. Act partisan and the transmission will be interrupted by managers to increase their personal interests in the application of accounting standards which are the basis of informing for investors. If the restrictions that limit the manager's opportunistic behavior, don’t exist accounting figures will be prepared and biased in financial reports. But conservatism by requiring proof and verification capabilities, limits manager’s opportunistic and partisan behavior.
In practice neutralized manager’s conservative bias behavior and delays identify profit as a result of understatement of net assets and profit. In the contract, the effect increases the value of the company because conservatism of manager’s opportunistic payments to their own and restrict other group such as shareholders. Company increased value among all groups in contract, increases division of the welfare in each group. In this sense, conservatism is an efficient conventional mechanism. According to Watts, conventional interpretation is the most important interpretation of conservatism. Although the conventional interpretation, emphasizes that the contract between the parties (such as the debt and reward management contract), the scope of this commentary to the organization (such as management accounting and control systems) is related. Moreover, the tax interpretation is linked with the conventional interpretation. Conventional interpretation has longer history than other conservative interpretations. For example, the lawsuits interpretation of the shareholder from 1960 seeking to increase shareholder’s lawsuits was created in the United States.

Tax interpretation from the 1909, seeking efforts that economic unit understatement taxes in America, accounting interpretation and legislators are followed by the requirements in the years 1934-1933 by SEC for financial reporting by companies. This was effectively carried out. (Watts, 2003)

Lawsuits Interpretation

Since the auditors and managers found that the lawsuits costs relating to further identifying the income and assets are more than understatement of the cost they found more enthusiasm for the low identified. (Watts, 2003)

Tax Interpretation

Since the taxable income and method of calculation taxable income was dependent on the reported income, consequently, calculation of the profit was also influenced and manipulated. Watts and Zimmerman (1979) affirmed the depreciation as an expense in America because the corporate tax to income obligation was America Treasury which was based on the fact that the depreciation should be considered as an expense in the financial statements and reports. Relationships and dependence between taxable income and reported income will provide an incentive to transfer income in future periods. With the transfer of benefit to future periods the tax value are reduced. Like conventional interpretation, on average, the incentive results into understatement of net assets.

Interpretation of Legislation

Rules also provide incentives for companies to create conservative financial statements. This phenomenon provides incentives for legislator and standards so that they remain conservative.
PAT and its relationship with conservatism

This section describes the nature of positive accounting theory and research. Positive Accounting Research tries to explain the behavioral communication in accounting. The research, is experimental and observational studies that are trying to find an answer to the question why the Board of Standards choose the particular way or why companies management choose certain methods among accepted accounting practices. Efficient market hypothesis cannot be the answer to such questions because the market can only show the effect of disclosure of accounting information on stock prices and cannot explain why corporate managers from different accounting methods only choose this method.

- Theory of Contract

According to the contract theory, each business unit has set various contracts between various entities associated with them. Due to the size of the business units the number of individuals involved in this contract, may vary. What is common to all contracts for all people is that they have the same rights and interests. Each person has to provide the resources and also has commitment to the business units.

- Agency Theory

Agency relationship is a contract whereby one group (owners), chooses individual or group as a steward or broker and is located in places in charge of providing a set of services specified in the business units. Contract involves delegating decisions to the server. In such a contract, the broker and owner of both parties understand that each act in their own interests. Since the agent (manager) may not act on the owner's interests and to pursue their personal interests, such as job security, personal credit, salaries and fringe benefits, etc. Such benefits may encompass risk management measures and possibly hurt their position to avoid and satisfy its primary outcome (not ideal). This makes it suboptimal for homeowners to achieve efficiency.

- School of positivism and PAT

PAT was introduced and spread by Watts and Zimmerman. Watts and Zimmerman explain how to choose the positive word in his theory and they stated: "We've borrowed the positive term of the economy, the term used in economics to explain and predict phenomena to clean research. According to the definition of the positive term in the economy, in our opinion, this term can be used to clean accounting research and to explain the phenomena of Accounting Research which would be will be beneficial. A positive term indicates creation the sign of the accounting such as signs that are often associated with a particular topic. "

http://www.ijhcs.com/index.php/ijhcs/index
PAT focused on relations between different persons of resources business units to ensure and explain how to help accounting in this task. Positive research in accounting gained importance in the mid-1960s. During the 1970s and 1980s, it became a major research paradigm. Before this time the research paradigm in accounting, accounting research was issued. Researchers such as Ball, Brown and Beaver have been studied experimentally the stock market reaction to the announcement of accounting earnings.

Ball and Brown (1968), using monthly data on the earnings and stock returns in the Wall Street Journal, looked at whether unexpected changes in accounting earnings lead to abnormal returns on the securities. They are based on the efficient market hypothesis which proposed that if the interest on the capital market as the data used in its stock, price will be adjusted according to new data.

Using statistical models predicted the expected profit entity. They’re also required by the model; predict stock market returns in the absence of information. That is, they must determine normal return of securities and so determine the abnormal returns.

Positive research hypotheses

There are three main hypotheses to explain and predict why an organization is opposed to special accounting procedures or support it in the texts and topics of PAT.

Reward management hypothesis

If the payments to the manager are directly calculated on accounting numbers (such as income, sales, property), any change in accounting method that the company uses, may affect the amount of director compensation. This change may occur due to the release of the new standard.

Debt hypothesis

Our hypothesis predicts that the high debt-equity ratio of the company will likely propel the management to use accounting techniques. High debt-equity ratio leads the company in debt agreements to face the requirements and conditions set by the lender.

Political cost hypothesis

This hypothesis predicts that large firms are more likely than small firms to use accounting practices and show low profit. Sized and large companies are considered an indicator of political attention. According to this hypothesis, it is assumed that if the company contracting parties know that the accounting profit represents the sole property of the owner to profit, in that case, this information may be expensive for the company.
Conclusion:

Range of conservatism in the financial statements is associated with the entity's policy. This range may be large or small. For example, predicted non-operating expenses can be registered or not. They can always be revised expectations. For instance, if you prefer a more optimistic business unit of analysis, non-operating expenses arising from lawsuits can be expected to be ruled out. Although everyone knows that accounting methods are conservative, but investors hardly express low amount of assets. Moderately, conservative investors provide excellent opportunities of production for the organization.

The usefulness of accounting data based on conservative policies can legitimately raise new questions. Conservatism is so strong in accounting that is more the kind of accountant, or intellectual, rather than a mechanism to respond to ambiguity. Perhaps, if there are serious doubts about the value of an item, conservatism begins to play. But, conservative accounting approach is in all aspects of accounting. On other hand, managers and business owners naturally tend to be overly optimistic. This excessive optimism causes over-statement of assets and income. Conservative is antidote to excessive optimism.

Carl Devine (Carl Devine, 1963) argues that inspiring optimism and put down pessimism is hard. Optimism creates a penny profit over pessimism. That loss is caused by a penny. The consequences of optimism are worse than the consequences of pessimism. Bearing an actual loss caused by over-optimistic estimate of the loss of profit opportunities arising from the too pessimistic valuation is more serious; because presumably the net asset values are expressed not least are prosecuted by investors, and auditors.

Due to unequal outcomes of excessive optimism versus pessimism, accounting rules for valuation and debts registration and operating and non-operating costs should differentiate. Non-operating expenses can be estimated, but non-operational income cannot. If the market value is less than cost, it can be detected. If the cost is more than market value, it could not be identified. In reporting information, the accountant may make one of two mistakes: first reject information that was later found to be true, second, accept that subsequently received information which is incorrect. The mistakes have the same statistical analysis outcomes whereby the mistake of the first kind is true and the mistake of the second kind is false.

The second mistake, in the audit is called "audit risk"; if the auditor judges that something is true while it is not, its consequences are more serious than the expected. Dwain argues that if the auditors accept items that are false, they are likely to damage investors. Recognizing the existence of these two types of risk can prove that conservatism is consistent with statistical probability analyses. So it is the logical way to deal with ambiguity. Users, particularly creditors, need to know the financial status of the business unit at least as it is what presented in the financial statements. They need to have a margin of safety to protect themselves against negative consequences. Despite criticism, the fans still believe that conservatism is followed in practice.
because experience has shown that accounting conservatism covenant is prudent and useful in an environment of uncertainty.
References


