Pobaschnig Marie-Therese, BSc

Conservatism versus Neutrality in Accounting

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O.Univ.-Prof. Mag. Dr.rer.soc.oec. Dr.h.c. Wagenhofer Alfred

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Author´s Declaration

Unless otherwise indicated in the text or references, or acknowledged above, this thesis is entirely the product of my own scholarly work. Any inaccuracies of fact or faults in reasoning are my own and accordingly I take full responsibility. This thesis has not been submitted either in whole or part, for a degree at this or any other university or institution. This is to certify that the printed version is equivalent to the submitted electronic one.

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List of Abbreviations

BC	Basic for Conclusion
CF	Conceptual Framework
Cf.	Confer
DT	Deferred Timeliness
E	Expected Value
ED	Exposure Draft
ED-CF	Exposure Draft "Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics and Constraints of Decision-Useful Financial Reporting Information"
EU	European Union
FASAC	Financial Accounting Standards Advisory Council
FASB	Financial Accounting Standard Board
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IESBA	International Ethical Standards Board for Accountants
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standards
LIFO	Last In First Out
Para	Paragraph
Pr	Probability
R & D	Research and Development
Sox	Sarbanes-Oxley Act
QC	Qualitative Characteristic
U.S. GAAP	United States General Accepted Accounting Principles
US	United States

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1 INTRODUCTION

Neutrality represents a desirable characteristic of the International Financial Reporting Standards (IFRS), which should prevent any bias or error in accounting, in order to provide faithful information in financial statements. Neutrality has been introduced as an objective to the Conceptual Framework (CF) to achieve the desired useful information for decisions. Neutrality is seen as the key to providing a correct representation of underlying conditions. Neutrality, however, does not exist if predetermined estimations and judgement biases have provided information.

Conservatism, as a prudent evaluation, can produce biases in financial reports. It evolves under circumstances and situations bearing uncertainty, e.g. with the estimation of the probability to collect doubtful debts or the probable useful life of assets or when companies have huge sums of collectable receivables. Taking future inflows and outflows into account, depends on the current provided information. Conservatism is considered helpful for making judgement calls.

Financial reporting attempts to support capital markets by providing information to investors in order to make decisions. Information is a determining component in accounting in a broad range of views. Numerous researchers provide evidence that financial reporting affects investment efficiency.[1] Accounting information may be essential for investment decisions, and further for debt contracts and, to be able to determine interest rates, assets and market values and cash flow predictions.

The main objective of the International Accounting Standards Board (IASB)[2] and the Financial Accounting Standards Board (FASB)[3] is to evolve accounting standards that produce financial information that helps investors to decide whether to provide resources to businesses.

[1] Cf. Balakrishnan et al. (2015).

[2] IASB (2015): **"***Our mission is to develop International Financial Reporting Standards (IFRS) that bring transparency, accountability and efficiency to financial markets around the world."* [online]

[3] FASB (2015): "*Since 1973, the Financial Accounting Standards Board (FASB) has been the designated organization in the private sector for establishing standards of financial accounting that govern the preparation of financial reports by nongovernmental organizations."* [online]

Moreover, the figures should provide information on whether the business's management has performed well with already received resources.[4]

An unbiased and neutral representation of information could be an essential tool for those issues. However, conservatism could also contribute towards efficient accounting under uncertainty. On the one hand, conservatism can have a major influence on the information content, which might lead to essential changes in results. On the other hand experts argue that conservatism could have the power to diminish the information content of an accounting system.[5] Chen/Deng (2010), for example, even discuss conservatism as a signalling device to transmit firms' information in order to raise external capital.

On the one hand, experts expose that firms reporting under conservatism are charged a lower interest rate. Conservative accounting can also be the reason that the firm's litigation risk of over-stating profits is considerably higher than the risk of under-stating profits.[6] This shows that firms may tend to report more conservatively in order to control signals and/or mitigate their risk from litigation. On the other hand, firms might aim to increase the probability of the occurrence of a good signal to raise funds and present a good performance to the public.

Neutrality, on the other hand, can be seen as the consequence of the aim of finding a remedy to those biases and misleading signals. Due to the fact that the IFRS are principle based, accountants operate in an area in which more than one interpretation and choice of accounting process exits. Further, it enables accountants to apply differing asset and liability valuations. Neutrality is argued to be applied in order to prevent earnings from being managed into any direction.[7] This means, neither a positive bias nor a negative bias should be included in judgements and estimations.

Trying to find harmonisation between conservatism and neutrality seems to be impossible as they internally contradict. This thesis deals with the accounting concepts of conservatism

[4] Cf. FASB (2015), Investors: Help us to improve Financial Reporting.
[5] Cf. e.g. Chen/Deng (2010); Gigler et al. (2009), p. 773; and Ball/Shivakumar (2006).
[6] Cf. e.g. Ball/Shivakumar (2006), p. 207–242; Basu (1997), p. 267–272.
[7] Cf. e.g. Abdullah/Mohd-Saleh (2014), p. 59; Henselmann (2008), p. 59.

versus neutrality. The aim is to identify the introduced accounting concepts and investigate their benefits and limitations to accounting and financial reporting under certain situations or/and under certain estimations.

First of all, this thesis examines the role of both concepts in the Conceptual Framework of the IASB. It then focuses on the objective of *information usefulness*, as this can be seen as the main triggering source of the discussed inconsistency from the IASB's point of view. By means of a binary information system the usefulness of positive or negative information will be assessed and examined to what extent conservatism or neutrality affects the information content.

The next part presents the significant recurring arguments on the vast debate of applying conservatism vs. neutrality in the IFRS. It will particularly focus on each argument, and examine the conservative or neutral perspective step by step.

Those arguments contend that it will be essential to consider different forms of conservatism as they have different consequences. As the IASB emphasises investors' protection, it is provoking to argue that investors may be more interested in losses than in profits. This cannot be adopted generally to all situations, however. Thus, prevalent arguments will be chosen and the reaction of bias i.e. conservatism to them discussed.

Nevertheless, it is the manager's responsibility to operate the business and achieve high performance. Managers prepare the information used by externals and it will be shown that it is evidently investigated that they possess discretion in accounting choices. Existing information asymmetries and managerial incentives may ask for accounting principles as a mean to mitigate those asymmetries. Finally, as the standard setters basically arose from a financial crisis and financial collapses are still a current topic, the focus will be on conservatism vs. neutrality in the financial crisis and the fair value approach to it.

2 Basic Concepts Of Neutrality And Conservatism

2.1 The Concept of Accounting Neutrality

The standard setters define neutrality in a similar way and both, the IASB and the FASB emphasis the absence of biases in financial statements.

IASB

"A neutral depiction is without bias in the selection of financial information. Financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgment in order to achieve a predetermined result or outcome."[8]

FASB

"Neutrality means that, in formulating or implementing standards, the primary concern should be the relevance and reliability of the information that results, not the effect that the new rule may have on a particular interest. A neutral choice between accounting alternatives is free from bias towards a predetermined result. The objectives of financial reporting serve many different information users who have diverse interests, and no one's predetermined result is likely to suit all interests."[9]

The standard setters argue that in order to provide a faithful presentation and comply with the objective of reliable information, the standards need to be neutral, which means free from any bias and error. Neutrality is not given in the case of predetermined estimations and judgements that bias information. Information should be provided in a neutral way, so users can make their own judgements and decisions. The accounting numbers' purpose is to provide information for decisions, and accounting figures should not be predetermined and designed to guide in any direction. Thus, it is essential that financial reports and given information do not obtain any bias, distortion or error.

[8] IASB (2010), p. 18.
[9] Cf. Financial Accounting Standards Board (2010), p. 3–4.

To comply with the principle of neutrality, it is indispensable not to prefer or favour any outcome of a statement. For example, if a business is concerned with presenting a good performance, neutrality ensures that it is impossible to discretionarily boost financial statements to, for instance, look more profitable.

2.2 The Concept of Accounting Conservatism

Paragraph 37 of the IASB's pre 2010 Conceptual Framework defines prudence as,

"[…] the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because the financial statements would not be neural and, therefore, not have the quality of reliability."[10]

Accordingly, conservatism evolves under circumstances and situations bearing uncertainty, e.g. with the estimation of the probability to collect doubtful debts or the probable useful life of assets. In those cases conservatism seems to be a support for finding decisions and making judgements. Conservatism in financial reporting historically refers to the principle of "orderly bookkeeping" or the "lower of the cost or market rule"[11], which could also be characterised by an extreme definition, stating conservatism as the anticipation of all losses but no gains.[12] The practice of conservative accounting asks for caution in situations of uncertainty. This could result in a systematic downward bias in terms of assets' book values and a systematic upward bias for their liabilities. Hence, the distortion is generally only temporary, according to the principle of congruency, which states that profits and losses may only be transferred into another period but do not change the total profit or loss

[10] Cited from Staff Paper (2014), Conceptual Framework / Prudence.
[11] First established by Gilman (1939).
[12] Cf. Bliss J. H. (1924).

regarding the entire period.[13] Basu (1997) explains conservatism in a way such that bad news is taken into account earlier than good news.

The literature defines prudence, caution and conservatism in different ways. Some argue that prudence involves more positive attributes, whereas conservatism refers to more negative ones. Talking about conservatism may cover numerous words and definitions and, therefore, there will be no explicit distinction between interpretations of prudence or caution further on. Conservatism is the most commonly used statement that can bundle all interpretations and also covers prudence and caution in its meaning.

2.3 The Contradiction between the Concepts of Conservatism and Neutrality

Neutrality is a manifested desirable characteristic of the IFRS, which should prevent any bias or error in order to provide faithful information in financial statements. Thus, neutrality has been introduced as an objective to the Conceptual Framework as an attribute to achieve the desired useful information. To provide a faithful presentation of true underlying conditions, neutrality should lay the foundation. Furthermore, neutrality is not given in the case of predetermined estimations and judgements.

The pre-2010 Framework points out in paragraph 37 that,

"*The preparers of financial statements do, however, have to contend with the uncertainties that inevitably surround many events and circumstances ... Such uncertainties are recognised by the disclosure of their nature and extent and by the exercise of prudence in the preparation of the financial statements.*"[14]

Accordingly, conservatism evolves under circumstances and situations bearing uncertainty, e.g. for the estimation of the probability to collect doubtful debts or the probable useful life of assets, or when companies have huge sums of collectable receivables and it is likely that a certain amount is not recordable. The concept of probability states that probable future

[13] Cf. e.g. Wagenhofer/Ewert (2015), p. 156.
[14] Also cited in Staff Paper (2014), Conceptual Framework / Prudence.

inflows and outflows rely on the currently provided information. For those reasons conservatism seems to be a support for finding decisions for judgements.

However, the intent is that assets are not overstated and debts are not understated. The big concern of the IASB when including conservatism in the Conceptual Framework was that it should not automatically allow an arbitrary over- or undervaluation of assets and liabilities, which would definitely harm the principle of neutrality. For example, it does not allow the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses. The crucial reason is that the financial statement would not be neutral and, therefore, no longer have the quality of reliability.[15] Nevertheless, the Framework currently agrees on conservative reactions in situations under uncertainty to ensure that uncertainty and risks are adequately considered.

[15] Cf. IASB (2013a).

3 CONSERVATISM VS. NEUTRALITY IN THE CONCEPTUAL FRAMEWORK

3.1 The Conceptual Framework

"*The Conceptual Framework sets out the concepts that underlie the preparation and presentation of financial statements. It is a practical tool that assists the IASB when developing and revising IFRSs."*[16]

The intent of the IASB is based on principles that are bundled into the Conceptual Framework. Byrne (1937, p. 369–372) already examines that *"[…] the basing of financial policies upon accounting statements, which in turn are not prepared with fundamentally right accounting principles, may lead to courses of action which, if too long pursued, will adversely affect the health of business."*

The Conceptual Framework is the basis to find solutions to solve problems of external accounting and further influence accounting standards directly. When there is no explicit Standard, principles are developed to support an accountant in doing audits or reports. To seek a solution whether conservatism or neutrality or both should be part of the IFRS, it is of critical importance to consider the IASB's basic principles and explicit position on those issues.[17]

"*The Conceptual Framework also includes a discussion of the necessary (and in some cases desirable) characteristics of useful financial information. To be useful, financial statements must provide information that is relevant and faithfully represents the economic activity it depicts. Prudence is one possible component of these characteristics and has attracted much attention."*[18]

[16] IASB (2013a), p. 18.
[17] Cf. Barker/McGeachin (2015).
[18] Cooper (2015), IFRS investor perspective: A tale of prudence, p.1.

Underlying assumptions of the Conceptual Framework:

Going concern- IASB (2015b, para 23)

The statements are prepared in a way that the business will continue in operation for the foreseeable future. This implies that there is no intention or need of liquidation. That means that businesses will not be forced to sell their assets or transfer their liabilities at prescribed prices or that interests are focused on receiving residual values.

Accrual Accounting- IASB (2015b, para 22)

Accrual accounting is the recognition of the effects of transactions and other events at the time of their occurrence rather than the time of payment. [19] *The idea is to capture current cash flows as well as future expected cash flows in order to present an accurate picture of the current financial situation.*

However, accrual accounting could build a basis for the contradiction between neutrality and conservatism. Through the implementation of conservatism, the principle of neutrality could be compromised by an unequal treatment of expected cash-inflows and cash-outflows. Accrual accounting enables the existence of conservatism according to Basu's explanation that conservatism is the differential verifiability required for recognition of profits and losses.[20] Watts' (2003b, p. 289) outcomes for conservatism show that gains may not be promptly taken into account when they occur, but losses are. He mentions the example of an increase in the asset's value caused by an increase in expected future cash flows: the gain is only then recognised when there is sufficient and verifiable evidence that the higher cash flow will be attained, whereas, losses may be anticipated at the time the information concerning the loss is received. Under conservative accounting, gains are recorded for the first time when they are sufficiently verifiable or even when they are realised. Hence, this could lead to asymmetric judgements of gains and losses.[21]

[19] IASB (2010).
[20] Cf. Watts (2003a), p. 207–208.
[21] Cf. Watts (2003b).

3.2 Objectives in the Conceptual Framework

The IASB has become a global standard-setter, and there is no limit to any particular country, group of countries, or continents. The IASB's aim is to produce standards that are implemented by the world's capital markets.[22] Their success can be seen from the use of the IFRS in more than one hundred countries all over the world.

The strict manifestation on their principle- based approach is fundamental and noteworthy. To serve investors with useful information is one of the major objectives and principles of the IASB. Information may be useful when it changes the expectations of the outcome of future events and consequently causes a difference to the decision. In order to cause a change in decision, information needs to have the characteristic of relevance, reliability and additionally, it has to be timely.[23]

The IFRS contributes explicitly to the definition of useful information by giving clear qualitative descriptors to each characteristic:[24]

- **Faithful representation of information** should be neutral which means without bias in the selection of financial information.

- **Relevance** means to make information capable of making a difference in users' decisions, predictive value, confirmatory value and obtaining materiality (entity-specific).

- **Reliability of information** can be achieved by the recognition of cost or value that can be measured reliably i.e. complete, neutral and free from error.

- **Decision Usefulness** is designed to contribute to a future orientated focus.

[22] Cf. Fleckner (2008), p. 281–283.
[23] Cf. Wagenhofer/Ewert (2015).
[24] See also definitions from Kothari/Barone (2011), p. 47–51.

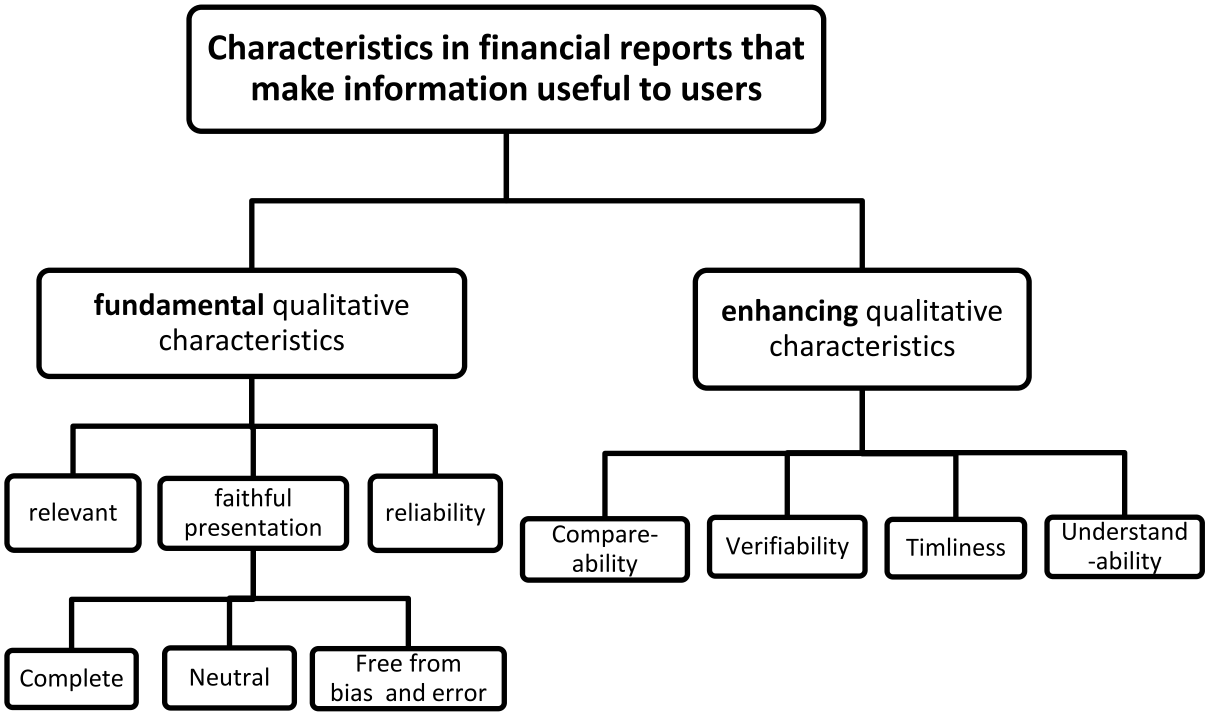

Figure 1: Characteristics that make Information useful.[25]

According to the definition provided by the IFRS, financial information is useful if it is reliable, relevant and faithfully represented. These are the fundamental criteria of the Conceptual Framework which could be enhanced.

Should the fundamental criteria not be fulfilled, information is argued not to be useful, and it cannot be made useful by making it more comparable, verifiable, timely or understandable. Notwithstanding, information is only useful if the requirements of relevance and faithful representation are met and it may still be useful even if it does not have any of the enhancing qualitative characteristics.[26]

Relevance is explained as the capability of making a difference to the decisions of users whereas faithful representation is elaborated by completeness, neutrality and freedom from

[25] Cf. Kothari/Barone (2011), p. 48.
[26] Cf. IASB (2010), Conceptual Framework.

errors.[27] However, this does not imply that it should be without purpose or that it should not influence behaviour. Moreover, the information should influence a user's decision, otherwise it would not contain the quality of relevance.[28]

Further, regarding the characteristic of faithful representation, freedom from bias and error could be precluded as a result of involving estimations incorporating management's judgement in reporting measures.[29] Kothari/Barone (2011) discuss the desire of completeness and neutrality of estimations for faithful representation under a certain required level of accuracy.

Neutrality is probably the most discussed qualitative characteristic as there seems to be a contradiction with conservatism, which is in itself another characteristic. Conservatism, which represents conservative actions and caution in situations under uncertainty, has been a component of the Conceptual Framework for a long time.

Neutrality should neither include nor exclude conservatism, but it should guarantee the absence of bias to achieve symmetry in the recognition of losses and gains. An aspect would be the prompt reaction to recently received information, in the form of recognition of corresponding losses and gains. Conservatism could fulfil this demand of symmetry by recognising losses, but opposing them by the treatment of gains, which are only recognised when they are verifiable. Thus, it seems that conservatism follows the concept of reliability but lacks a link to faithful presentation.[30]

In most meetings the IASB unanimously discussed the introduction or displacement of prudence and mostly they agreed on the retainment of neutrality and displacement of conservatism as indispensable for financial statements.[31] The framework states that should conservatism be part of their framework, this could harm the principle of neutrality. Intense debates are ongoing on the possible inconsistency between conservatism and neutrality.

[27] Cf. IASB (2010), Conceptual Framework.
[28] Cf. Kothari/Barone (2011).
[29] Cf. Kothari/Barone (2011).
[30] Cf. Barker/McGeachin (2015), p. 14–15.
[31] Cf. FASAC meeting from 16.5.2005: FASB Investors: Help us to improve Financial Reporting.

3.3 The Debate between Conservatism and Neutrality in the Conceptual Framework

Due to the globalisation of capital markets, the significance of international financial reporting has increased substantially. Some argue that the IFRS is the accountants' language worldwide.[32] Countries with different cultures, different languages, and different ethical beliefs deal with the IFRS. Thus, the intent to produce commonly accepted and interpretable accounting standards may seem to be more trivial than it actually is. With regard to the wide diversity of users, it seems to be essential that the IASB require neutrality of information in the International Financial Reporting Standards.[33]

Originally, the pre-2010 Conceptual Framework included prudence in their common accounting principles in order to ensure the reliability of financial statements. In addition, the appendix stated that this does not allow an arbitrary undervaluation of the company.[34] That seems to be an attempt to reach a compromise between neutrality and conservatism.

Conceptual Framework 1989: *"Prudence is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated."*[35] Notwithstanding this trial of a compromise, extensive discussions arose around the contradiction between conservative and neutral accounting.

On the one hand, literature highlights the strong urge of conservatism in accounting. On the other hand, the international standard setters pay little attention to the critics. Furthermore, the IASB argues that the principle of reliability of information would suffer under a deliberate undervaluation of assets and overvaluation of liabilities. The argument seems to concern the frequent rejecting of conservatism in order to avoid bias in information. There seems to be no possible solution to harmonise those principles and prudence faded in the CF. Finally, within the revised CF in 2010 prudence was displaced in the Conceptual

[32] Cf. Zülch/Hendler (2015).
[33] Cf. IASB (2010), Conceptual Framework.
[34] Cf. IASB (2010).
[35] IASB (2013a), p. 189.

Framework. The explanation states that first, it is inconsistent with neutrality and, second, an undervaluation in the current year leads to an overvaluation in the following years.

In 2010 the CF stated in QC14 that, *"[…] a neutral depiction is not slanted, weighted, emphasised, de-emphasised or otherwise manipulated to increase the probability that financial information will be received favourably or unfavourably by users. Neutral information does not mean information with no purpose or no influence on behaviour. On the contrary, relevant financial information is, by definition, capable of making a difference in users' decisions."*[36]

However, the discussion did not stop and an extensive public consultation identified the priorities to update the Conceptual Framework. The goal to explore changes induced the IASB to issue a Discussion Paper in 2013 (without support of the FASB), "*[…] to obtain initial views and comments on important issues that the IASB will consider as it develops an Exposure Draft of a revised Conceptual Framework."*[37]

In the Discussion Paper (2013) proponents of neutrality argue that

- having conservatism and neutrality in the framework would be a contradiction. As already argued in the pre 2010 Conceptual Framework, conservatism does not allow deliberate valuations and it would lead to a biased preparation of financial statements. This consequently leads to a breach of neutrality and unbiased information. [38]

- *"[…] deliberately understating assets or overstating liabilities in one period often leads to overstating financial performance in later periods."*[39]

[36] IASB (2010), p. 18.
[37] IASB (2013a), p. 5.
[38] Cf. IASB (2013a), p. 185-188.
[39] IASB (2013a), p. 185.

The arguments against the removal of conservatism in the Discussion Paper (2013) state that

- non-conservative estimations in financial statements may support over-optimistic management desires.

- the removal leads to a recognition of uncertain assets and a non-recognition of possible losses or liabilities.

- merely having neutrality in the framework increases the use of current value measurements such as the fair value approach which some view as *"[…] inherently unverifiable and prone to error […]"*.[40]

However, it suggests that the agreed terms from the CF 2010 should not be reconsidered. Based on this fact and the published issues, it seems that conservatism has no future in the IFRS. The paper states that considering prudence as an additional factor would result in a significantly different outcome, which is not the intent of unbiased, neutral information.[41] Despite this criticism and of the continuing exclusion of prudence, the debate has not abated. Consequently discussions that prudence should be a fundamental objective of financial statements are ongoing.

The IASB as well as the FASB are private organisations with the emphasis of independency. However, there may occur circumstances that make their efforts to ensure independency vulnerable and weak to external influences.[42] First of all, the European Union also threatens the IASB's independence by the endorsement process. Second, the funding of the IASB depends on voluntary contributions. Most of them are collected by big accounting companies. But also the Council of the European Union regularly discusses the "Future of IASB-Funding" which has led to the result that the European Union became a big trustee of the IASB.[43]

[40] IASB (2013b), p. 189.
[41] Cf. IASB (2013a).
[42] Cf. Fleckner (2008), p. 283.
[43] Cf. Fleckner (2008), p. 296–298.

Since the financial crisis in 2008, caused by overvaluation of assets, conservatism is an ongoing concern of the European Union. It now seems to be the EU's strong desire to integrate conservatism into financial statements. Since the IASB has refused to implement this principle, the EU has considered the withdrawal of provision for future financial resources. Finally, however, the IASB has been funded by a budget planned until 2020. [44]

Taking this into consideration, the Conceptual Framework and especially conservatism was a major issue at the IASB meeting in May 2014. The agreement provided positive news to all conservatism proponents. First, all members of the IASB agreed to a reintroduction of prudence to the Conceptual Framework. Second, the updated explanation defines prudence as implementing caution for judgments under conditions of uncertainty. Further, they submitted that the exercise of prudence has to be consistent with neutrality and should not allow the overstatement or understatement of assets, liabilities, income or expenses. [45] Finally, the IASB debated the value of considering conservatism for conclusions of financial statements and standards. The prompt "harmonisation" of neutrality and conservatism does not seem to be comprehensible to many people, as they were seen as inconsistent in prior discussions. Not only does the IASB seem to contradict this in the new publication of its view of conservatism and neutrality, but the literature also does not reconcile neutrality and conservatism. The IASB suggests that neutrality could be ensured through conservatism, by compensating for the tendency of the management to report optimistically. Furthermore, Wagenhofer (2014, p. 266) notes that the interpretation of prudence deviates from the official definition. He analyses the interpretation of conservatism as a significant approach to neutrality. In order to avoid the inconsistency between conservatism and neutrality, conservatism is suggested to be merely a principle to ensure caution towards the overstatement of net assets. The differential verifiability of the recognition of gains and losses does not seem to be part of that reintroduction of conservatism.[46]

In May 2014 the tentative decision of the IASB stated, *"[…] prudence as the exercise of caution when making judgments under conditions of uncertainty. The exercise of prudence is*

[44] Cf. Wagenhofer (2014), p. 265.
[45] Cf. IASB (2013a), p. 184–185.
[46] Cf. Barker/McGeachin (2015).

consistent with neutrality and should not allow the overstatement or understatement of assets, liabilities, income or expenses […].”[47]

During the post discussion in September 2014, the IFRS agreed to pursue issues of conservatism to meet the need of long-term investors in a reporting entity in a tentative decision.[48] The conclusion could be that this contributes to the explanation that conservatism is an unalterable component of the accounting process.

In 2015, prudence is planned to be reintroduced as part of the Conceptual Framework. The aim is to apply caution under uncertainty in order to avoid overstatements of net assets. Steve Cooper (2015), a member of the IASB, commits that the old definition of conservatism was not clear enough and left space for diverse interpretations and implications in financial reports. He states that a conservative bias might sometimes have been desirable. According to his article, published on the official IFRS website, he regrets that the IASB has not clarified the meaning. He even suggests eliminating all references to the concepts and "renewing the definition for good-quality accounting" characteristics. That was the first time, someone has considered altering something on the principle of neutrality and not merely for or against conservatism. However, the solution was that, *"[…] we have reconsidered, and in this Exposure Draft propose the alternative of retaining (reintroducing) the concept but clarifying exactly what we mean by it."*[49]

In the IASB's (2015a) basis for conclusions on exposure draft *Chapter 2—The qualitative characteristics of useful financial information* defines prudence in paragraph 2.18 in two ways:

- **Cautious prudence:**
  "*The IASB considers that prudence (defined as the exercise of caution when making judgements under conditions of uncertainty) can help achieve neutrality in applying accounting policies (the aspect of neutrality described in paragraph BC2.7(b)). Thus,*

[47] Staff Paper (2014), Conceptual Framework / Prudence.
[48] Cf. Staff Paper (2014), Conceptual Framework / Prudence.
[49] Cooper (2015), IFRS investor perspective: A tale of prudence, p.3.

cautious prudence is a factor in giving a faithful representation of assets, liabilities, equity, income and expenses."[50]

- **Asymmetric prudence**
  "[…] is a necessary characteristic of useful financial information and that prudence cannot be consistent with neutrality. The IASB disagrees with this view. However, the IASB also thinks that not all asymmetry is inconsistent with neutrality."[51]

[50] IASB (2015a), BC 2.9, p. 21.
[51] IASB (2015a), BC 2.11, p. 22.

4 Effects of Neutrality and Conservatism to the Decision Usefulness of Information

4.1 Accounting Information for Decisions

The IASB believes that accounting interacts as a mean of communication between people who provide resources to the business and the business itself.[52] Originally, the objective of financial reporting from the standard setter's point of view involved the following roles:

- The role of Stewardship.
- The role of Decision Usefulness.

Step by step the stewardship role has been displaced by the growing emphasis on financial reporting as a means of information, useful for making investment decisions.[53]

Most experts discuss accounting information in the form of financial statements or annual reports as the outcome of accounting processes. Kieso et al. (2012, p. 5) argue that for any economic decision, there is the need of accounting information. Investment decisions, monitoring activities, stewards' evaluations or regulatory measures are the result of the use of accounting information.[54] Dickhaut et al. (2010, p. 235) state that, "*Accounting has a comparative advantage over less formal information sources because it is based on reliable and quantified information derived from past exchange.*" This clearly contributes to the explanation of the standard setters' need for reliable information.

The efficiency of high quality information for the application in accounting is strongly emphasised. The fundamental role of accounting is examined by:

[52] Cf. FASB (2015), Investors: Help us to improve Financial Reporting.
[53] Cf. Lennard (2007).
[54] Cf. Hansen/Mowen (2007), p. 5.

- aiding exchange evaluation with
- reliable and quantified information. [55]

"The objective of general purpose external financial reporting is to provide information that is useful to present and potential investors and creditors and others in making investment, credit and similar resource allocation decisions."[56]

Considering the requirement of useful information to consequently serve decision usefulness, the company would have to make their entire internal information available to external users. This again would cause a flood of information, which is firstly, cost-, analysis- and time intensive and secondly, it might destroy the entity's competitive advantage, which all seems to be suboptimal for external and internal users.[57] Thus, the principle of relevance of information and also its further interpretation is essential for getting useful information.

Pellens et al. (2014) refer to an example, stating an enterprise which does an annual examination of their employees' satisfaction and know-how. The results can be seen as significantly positive, which might result in positive cash flows. This would serve investors with useful information for decisions. Since employees' know-how is an intangible asset and difficult to quantify, it can never be part of financial reports even if there is a possible future economic flow. [58]

[55] Cf. Dickhaut et al. (2010), p. 236–238.
[56] IASB (2010), Conceptual Framework.
[57] Cf. Pellens et al. (2014), p. 92.
[58] Cf. Pellens et al. (2014), p. 92–95.

4.2 The Information Content for Decision Usefulness affected by Conservatism and Neutrality

INFORMATION CONTENT

One fundamental argument of the IAS is that information fulfil the criteria of usefulness while being relevant. When information is relevant to a decision, it is argued to contain information content. Relevance of information may be one result of information, containing information content.

Kothari/Barone (2011, p. 49) argue that, *"[...] for a representation to imply a degree of completeness, neutrality, or freedom from error that is impracticable would diminish the extent to which the information faithfully represents the economic phenomena that it purports to represent. Thus, to attain a faithful representation, it sometimes may be necessary to explicitly disclose the degree of uncertainty in the reported financial information."*[59]

The following section will look at different situations in information systems, focussing on information that is useful and information that is not useful. Furthermore it will examine the information content applying conservatism or neutrality to the system. To apprehend the signalling role in an information system it is essential to understand the structure of the system which is applied in the model from e.g. Gigler/Hemmer (2001), Wagenhofer/Göx (2010) and Wagenhofer/Ewert (2015).

A binary information system is considered that reports a signal y $\{y_H, y_L\}$ under the assumption of the occurrence of only two possible cash flows x $\{x_H, x_L\}$; x_H for the high cash flow and for the low cash flow x_L and $x_H > x_L$. Those signals obtain the probabilities of f $\{f_H, f_L\}$, where f_j [0,1] stands for the accurate cash flow reporting. In other words, f_L is the probability that x_L occurs as a result of signal y_L and f_H is the probability that x_H occurs as a result of signal y_H. Information is said to be useful, if it results in a change in the expected value E. The

[59] Kothari/Barone (2011), p. 49.

following section will include an examination and overview of the systems and equations of Wagenhofer/Ewert (2015, p. 166-181).

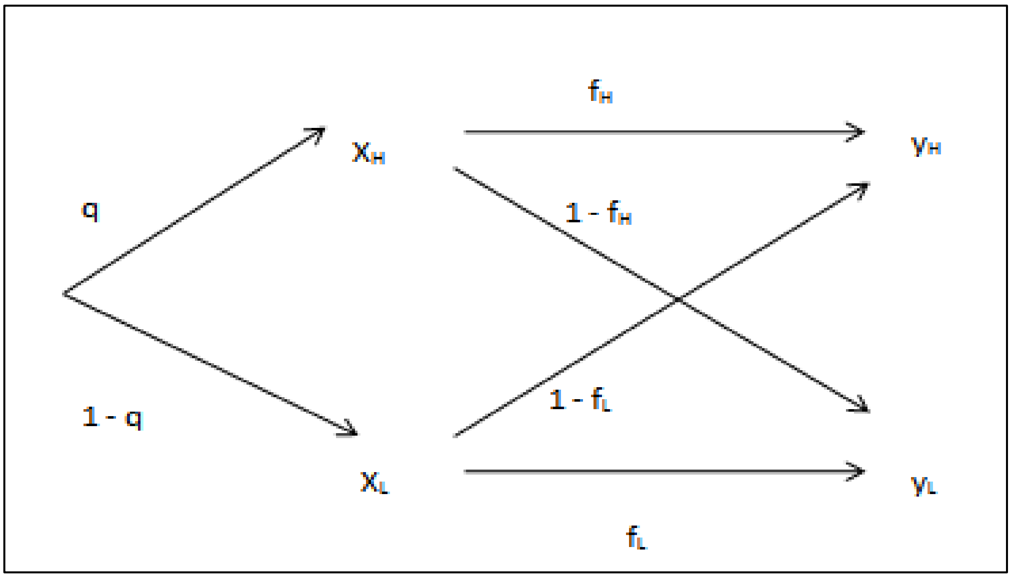

Figure 2: Signals in an information system.[60]

The probability $\Pr(y_H, y_L)$ that each of the two signals occurs results in:

$$\Pr(y_L) = (1-q) * f_L + q * (1-f_H)$$

$$\Pr(y_H) = q * f_H + (1-q) * (1-f_L)$$

Without any information, expectation of the cash flow *x*, the expected cash flow is:

$E(x) = q * x_H + (1-q) * x_L.$

When a signal y $\{y_H, y_L\}$ can be observed it changes to:[61]

$$\mathrm{E}(\mathrm{x}; y_L) = \frac{(1-q) * f_L * x_L + q * (1-f_H) * x_L}{\Pr(y_L)} < E(x)$$

[60] Wagenhofer/Ewert (2015), p. 166.
[61] Wagenhofer/Ewert (2015), p. 167.

$$\mathrm{E}\ (\mathrm{x}; y_H) = \frac{(1-q) * (1-f_L) * x_L + q * f_H\ *\ x_H}{\mathrm{Pr}(y_H)} > E\ (x)$$

Observing signal $y_L \rightarrow E\ (x) > \mathrm{E}\ (\mathrm{x}; y_L)$ and $y_H \rightarrow E\ (x) < \mathrm{E}\ (\mathrm{x}; y_H)$.

In a perfect system $f_L + f_H = 2$. This would provide exact and fully accurate information about the right cash flow situation caused by their signal. In contrast, if $f_L + f_H = 1$ there is no information given in the system. That leads to the result that the higher $f_L + f_H$, is the more information content the signal obtains.

In accounting systems without biased information, both signals would be equally probable and $f_L = f_H$. This represents the aim of achieving the neutral characteristic of information. Irrespective of the value of f, observing one signal also means observing the other signal, which leads to the consequence that both signals obtain the same level of information content. This would be the goal to achieve.

Conversely, conservatism increases f_L and simultaneously decreases f_H by the same amount ($f_L > f_H$). Conservatism, therefore, has the effect that it x_L is more probable when observing a bad signal. As a result, conservatism increases the probability of a bad signal (y_L), whereas the outcome probability of a good signal is reduced. An increase in f_L leads to a higher probability for y_L. The information content could be derived from the change of $E\ (x)$ and $\mathrm{E}\ (\mathrm{x}; y_L)$ which implies that in situations under uncertainty, bad signals are more likely to be published but simultaneously also implies that good signals obtain more precise information.[62]

Moreover, the assumption is that $f_H \geq 1 - f_L$ (which contrarily implies that $f_L \geq 1 - f_H$) to retain that the cash flow y_L is more likely to be reported than y_H if the cash flow equals x_H.[63] To elaborate on this, f_L is the probability of the right report. This has the consequence that only bad signals are reported entirely and further integrated in accounting systems. Under the assumption that f_H is significantly lower, the good signal y_H contains more information

[62] Cf. Wagenhofer/Ewert (2015), p. 166.
[63] Cf. Wagenhofer/Göx (2009), p. 587.

content by reporting a high cash flow. [64]Considering an extreme case of conservatism where $f_L = 1$, the signal y_H provides full information for the cash flow $x_{H,}$ whereas, y_L would obtain significantly less information content.

However, changing the level of conservatism in an information system simultaneously changes *type I error* and *type II error* terms, which are important when making decisions about economic investment projects. For the elaboration on these error terms see *Chapter 5.4.2 Effects of Investment Policies and Covenants*.

A further aspect would be to provide information generally. Extending this model, the possibility is added that the information system can also lead to no signal. Thus, conservatism has the effect that prevailing bad signals obtain an impact on accounting reports and good signals are omitted, which leads to the result that observing a good signal or no signal would not change anything.

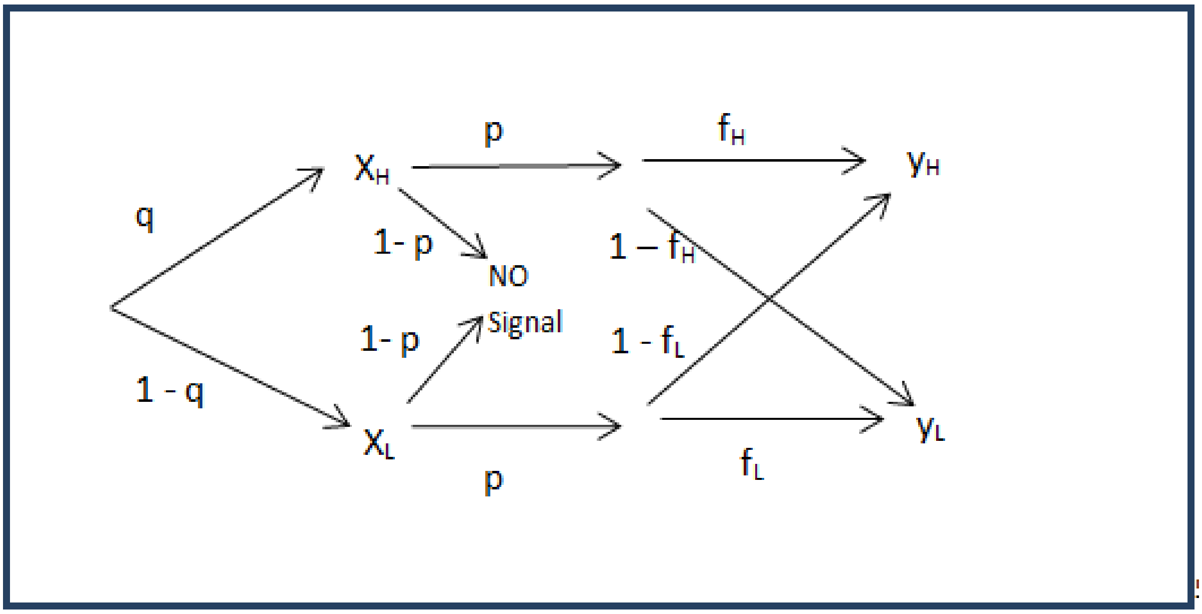

Figure 3: Signals in an extended information system.[65]

This extended system does not change the probability of y_L. However, if there is no report it is the average of signal's y_H probability and the expected value $\mathrm{E}\,(x)$. The lower the

[64] Cf. Wagenhofer/Ewert (2015), p. 167.
[65] Cf. Wagenhofer/Ewert (2015), p. 169.

probability p, the lower the probability is for y_L.[66] The substantial change to the prior model (Figure 2) is that the probability for a bad signal is reduced, which simultaneously increases its information content and furthers the expected value to receive the right information.

Ewert/Wagenhofer (2014) mention the example of extraordinary depreciation. In case of no signal or a good signal nothing happens to fixed assets, whereas, if a signal of bad environmental circumstances (y_L) occurs, the company has to depreciate the asset. This could illustrate that under a high level of conservatism, there is only information content if signal y_L occurs. If the firm does not value their fixed assets, it could be the result of either no signal or a good signal.

Under these estimations, conservatism provides useful information only in the case of bad circumstances but does not support the firm in good situations. Valuing the firm in the case of no depreciation therefore also includes the probability of no signal or a good signal. This may have the consequence of an underestimation of the firm's asset value.

As neutrality is assumed to be achieved by current value measurements, in the case of good signals, the asset could be valued upwards. Taking this into consideration, y_H again gains information content as a result of the distinction from the result of no signal. Accordingly both y_H and y_L would again obtain the same level of information content and may again lead to starting position regarding $f_L + f_H = 1$ for no information and $f_L + f_H = 2$ for full information.

By improving the accounting system's accuracy, the information content of any signals declines.[67] Thus, the situation and circumstances under which a signal, whether low or high, occurs needs to be carefully considered.

Empirical results of repeated Accounting Write- Offs and the Information Content of Earnings

Elliott/Hanna (1996) investigate the information content of earnings as an effect of large non-recurring or unusual charges against earnings. Their objective is to define how the

[66] Cf. Ewert/Wagenhofer (2015), p. 169.
[67] Cf. Wagenhofer/Ewert (2011a), p. 150–152.

information content changes as a result of extraordinarily high, aperiodic accounting write-offs. The examination is enhanced by analyses of stock-rate reactions in relation to the date of earnings announcements.

Elliott/Hanna (1996) suggest that accounting write-offs may distort companies' earnings outlook as a consequence of incurred losses in a way that past and future earnings seem to be better than they actually are. Thus, the further investigation is the investor's reaction to the record of such a special item.

The examination is based on prior research which deals with the effect of multiple stock price write-offs. The authors' data, provided by Compustat, is based on the quarterly documentation of nearly 3,000 firms having between zero and four and more write-offs from the first quarter of 1974 to the fourth quarter of 1995. The results provide evidence for the frequency of reporting negative special items being three times higher than for positive ones and this has further increased over the years. They also contribute to the argument that the problem with write-offs is that a company's earnings statement might be distorted. The claim is that it provides the possibility to pack losses in one period in order to brighten past and future statements. Earnings distortions can also occur if firms transfer normal components of operating expenses into special items, and as a result, they may increase both the current and future operating earnings before special items. This could be seen as the *big bath* approach, which is explicitly discussed later on.

5 Arguments and Perspectives of Neutrality and Conservatism

In May 2015 a document was issued contributing to the current discussion and the most important issues concerning conservatism vs. neutrality. The following arguments present the significant recurring arguments on the big debate of applying conservatism vs. neutrality in the IFRS.

The following points summarise the arguments in favour of the IFRS being conservative:

- Forms of Conservatism
  "[…] academic research has suggested that some forms of conservatism […] have a role to play in financial reporting in some cases. However, there are different views about what forms of conservatism are helpful, when and why."[68]

- Investor's Perspective
  "Financial reporting leads to stronger capital markets by helping investors make informed decisions."[69]

- Investor`s Perspective
  "Investors are more concerned about downside risk than upside potential. Prudence helps to address this concern." [70]

- Asymmetric Information between Firm Insiders and Outsiders
  "*The exercise of prudence helps to align the interests of shareholders and managers and can reduce moral hazard."* [71]

- Management's natural Bias towards Optimism
  "Prudence is needed to counteract management's natural bias towards optimism." [72]

[68] IASB (2015a), p. 20.
[69] FASB (2015), Investors: Help us to improve Financial Reporting.
[70] IASB (2015a), p. 20.
[71] IASB (2015a), p. 20.
[72] IASB (2015a), p. 20.

- The Role of Conservatism vs. Neutrality in Financial Crisis
  "T*he financial crisis has demonstrated the need for prudence when making estimates".*[73]

These arguments basically capture the major issues and diverse views of the debate to apply conservatism in the Conceptual Framework, which provides a good survey of the affected issues and leaves a broad scope for debate. The next section will focus on each argument and examine the benefits and the limitations of the conservative or neutral perspective for each.

[73] IASB (2015a), p. 20.

5.1 Forms of Conservatism

"Academic research has suggested that some forms of conservatism have a role to play in financial reporting in some cases. However, there are different views about what forms of conservatism are helpful, when and why."[74]

There may be differing intentions for conservatism because different forms can lead to different results. Considerations of the form and the application of conservatism might follow different objectives. Watts (2003a) discusses covenants as the solution to reach efficiency of conservatism for both forms. He argues for covenants which define lower management's compensation as a consequence of less recognised profits.

5.1.1 Unconditional Conservatism

Unconditional conservatism or so-called "balance sheet conservatism" refers to the ex-ante recorded type and is seen as independent of news i.e. new information.[75] That means, the decision to apply conservative accounting choices has already been taken before any information is available about any losses or gains. Basu (2005) states that this mostly appears because of taxation and regulative incentives.

The treatment of Research and Development costs provides a good example. Most of the costs are recognised as revenue expenditure instead of assets. This leads to understatement of assets in the case of the investment generating a positive present book value.[76] A further appearance of unconditional conservatism is the general allowance for doubtful debts accounts.

However, Mora/Walker (2014) debate that unconditional conservatism leads to understatement of net assets but need not necessarily lead to understated net income. Considering the total period of an investment project, the full amount of the asset is depreciated and merely the timing of the charge is affected. Thus, unconditional conservatism causes lower income in earlier periods of the project and results in a higher

[74] IASB (2015a), p. 20.
[75] Cf. Ball/Shivakumar (2006).
[76] Cf. Mora/Walker (2014), p. 8–9.

income in later periods. However, difficulties could arise by a change of expectations concerning the investment's profitability once the investment has taken place. In that case, it is essential to find the causes of the changes – whether they have emerged from inside or outside the company – and also whether they result in good or bad changes.[77]

Many experts have the view that unconditional conservatism reduces the value relevance of financial statements and that it does not reject Earnings Management but many firms choose unconditional conservatism because of the effects of lower taxation payments and fear of litigation.

LITIGATION

The legal liability, or the legal environment, has a major influence on managers, auditors and investors to comply with their official duties because of the perceived level of threat of prosecution.[78] The fear of litigation costs may also have a notable impact on financial statements. Litigation determines asymmetric payoffs, which leads to the result that a company is more likely to bear litigation costs by overstating net assets than by understating them.

Watts (2003b), Basu (1997), Kothari et al. (1988) among other academic researchers point out that litigation generates conservatism. The investigations in the USA show that in years with an increase in litigation, conservatism has also risen.[79] It appears to be extremely challenging to produce standards applied from different cultures and societies, as they also have different law regulations. For example, under common law countries (e.g. Australia, Canada, USA) litigation might be a more severe issue. Ball et al. (2000) finds more conservatism in earnings in those countries. Further examination nevertheless shows that neutrality plays a more significant role in these common law countries, as the law tends more to investors' protection. This argument contributes to the standard setters generating their standards because of investor's interest. Ball et al. (2000) debates that common law countries may experience more conservative earnings underlying strong legal requirements

[77] Cf. Mora/Walker (2014).
[78] Cf. Palepu/Healy (2013).
[79] Cf. Basu (1997).

for neutrality. Whereas, in countries with code law regulations, which include more conservatism by law, earnings tend to be less conservative. In addition Ball et al. (2003) illustrate that in four Asian countries (Hong Kong, Malaysia, Singapore, and Thailand) law does not have such a big influence on the financial reports of earnings. In those countries, the auditing of financial statements tends to be less rigorous due to strong family ties and insider networks. Watts (2003b) argues that the degree of conservatism also depends on the contractual agreements involving accounting figures and their binding to laws. However, due to the globalisation of capital markets, litigation will possibly grow to become a considerable issue for all businesses around the world.

TAXATION

The correlation of earnings and taxation is discussed as another major issue which motivates conservative accounting in contrast to staying in a neutral position and carrying more tax payments. Taking more losses into account than profits could mitigate the present value of taxes and simultaneously, raise the firm`s value. The delayed recognition of profits may lead to deferred tax payments.[80] Specific depreciation methods in accounting as well as the LIFO-method used to have an impact on tax values but have been eliminated. Burgstahler et al. (2006) investigate the impact of earnings management based on the tax-rate for private and public companies. The results indicate that the higher the tax rate, the more earnings are managed in private companies, whereas an examination of public companies shows that they do not react so sharply to increases in the tax-rate. They further elaborate that the higher the enforcement, the lower the practice of earnings management. Thus, earnings quality may be enhanced. However, a conservative reporting followed by an understated income may lead to less tax payments in the recent period.

5.1.2 Conditional Conservatism

Conditional conservatism refers to the ex-post recorded type and it depends on news i.e. new and current information.[81] That can be examined by companies promptly recording the book value of net assets when receiving bad news but not writing up as quickly when

[80] Cf. Watts (2003a), p. 209–210.
[81] Cf. Ball/Shivakumar (2006).

receiving good news. Others contend that under strong unconditional conservatism, conditional conservatism no longer exists. An example for conditional conservatism would be the "lowering of cost market accounting" for inventory and impairment accounting for long-term assets.

Barker/McGeachin (2015) examine numerous pieces of empirical research which illustrate an implicit demand by the market for conditional conservatism. This can be illustrated by Basu's deferred-timeliness (DT) measure.[82] Basu (1997) examined the impact of conditional conservatism on the persistence and timeliness to earnings.

The basis for Basu's regression is the stock price, which is seen as an indicator for received information of good news or bad news as sources other than current earnings. The stock price additionally is assumed to be a representative indicator of the company's true value. A positive unexpected return is the result of good news and vice versa.

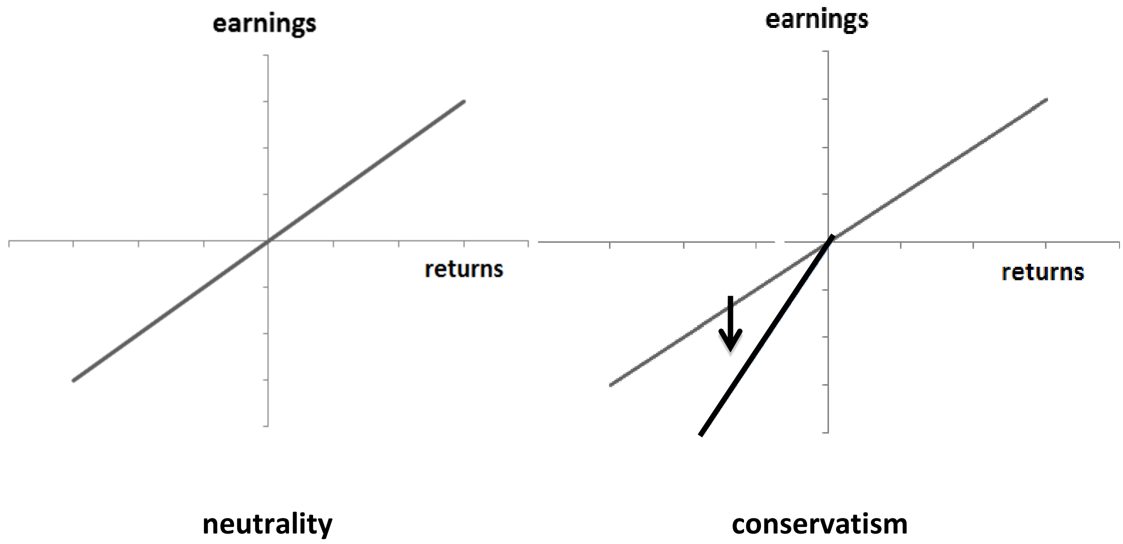

Figure 4: Hypothesized association between earnings and returns under conservatism.[83]

[82] Cf. Basu (1997).
[83] Cf. Wagenhofer/Ewert (2015), p. 163 and Basu (1997), p. 12.

$$\frac{EPS_{jt}}{Price_{jt-1}} = \alpha_0 + \beta_0 * DUM_{jt} + \beta_1 * Return_{jt} + \beta_2 * (DUM_{jt} * Return_{jt}) + \varepsilon_{jt}$$ [84]

EPS Earnings per Share (standard set by the price)

Price Market Capitalisation

DUM Dummy-Variable (1 if r*eturn* < 0; 0 if *return* ≥ 0)

Return Stock Return

Return < 0: negative event

Return ≥ 0: positive event

Regarding only a single period:

- negative event (*return* < 0) → *earnings* < 0

- positive event (*return* ≥ 0) → *earnings* > 0

This graph precisely illustrates the bias of conservatism in contrast to neutrality. Conservatism or deferred timeliness is basically reflected by the coefficient β_2. This reflects the sharpness in response to a negative event. Respectively, receiving positive news, the regression does not react in a sensitive way. Conservatism with this measure shows that earnings react faster and less persistently to bad news than to good news. β_2 gets activated by the return being negative and thus, it shifts the regression downwards.

The measure, however, can only be applied to companies which have a stock price on the capital market. The measure is critically examined by lots of research which leads to debate on accounting being a factor which influences stock prices and the company's value on the capital market.[85] Conservatism can be shown as a negative event being reflected earlier in earnings than a positive one. However, regarding more than one period, the aggregation

[84] Cf. Basu (1997).

[85] Cf. e.g. Givoly et al. (2007), Pellens et al. (2014) and Ball et al. (2013).

effect and cumulated effects increase drastically. The measure picks up more bad news than good, which in turn could imply that there exists more precise information for good news. This suggests the information regarding good news is more accurate because there is less of it in the measure.

Givoly et al. (2007) try to provide evidence that more factors than merely conservatism influence the regression. They elaborate on influences including the aggregation effect of earnings and cumulated effects, economic and natural events which are also reflected in the earning accruals and lastly, the date of publishing disclosure. All of these could have an impact on the earnings statement. Thus, Basu's deferred timeliness measure may not be seen as a manifested law and further, it cannot be safely asserted that conditional conservatism could be an overall positive principle for all firms.[86]

TIME OF DISCLOSURE AND PUBLISHED EARNINGS

The time of issuing information represents a significant factor for accounting systems and stock market reactions. The stock market is assumed to react faster to information than a company is able to present their earning statements. Stock market prices are said to react to changes of asset values at the time they occur, no matter if they are losses or gains.[87] The capital market is also argued to react to bad information from conservative reporting through decreasing stock prices. A neutral management will report positive events much earlier than a conservative management and respectively, bad information will be published earlier by conservative managements. The market to book ratio is argued to show conservatism, because of the lower book value of net assets compared to the equity value. Controversial, neutrality might have the consequence that positive information is published earlier than negative information, which automatically leads to stock price increases. As earnings are not captured promptly in the published statement and earnings will respond later to the positive event, the market to book ratio[88] will indicate the company being conservative, which actually would not be the fact.[89]

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[86] Cf. Givoly et al. (2007).
[87] Cf. Watts (2003b), p. 290.
[88] The market to book ratio can be compared to prior regression stating EPS/Price.
[89] Cf. Givoly et al. (2007).

5.2 Investors' Perspective to Conservatism vs. Neutrality

"*While we believe sound financial reporting leads to stronger capital markets by helping investors make informed decisions, it is important to note that the purpose of financial reporting is not to create the illusion of economic stability. The purpose of financial reporting is to provide an objective look at a company's financial situation.*"[90]

While several studies propose that it is not possible to meet the information interests of all stakeholders affected by the entity, the IASB focuses on equity investors' interests, which involves needs that should be common to all groups.[91] This can be seen as the explanation why the IASB and FASB are interested in providing financial information related to the investor's interests.

Kothari/Barone (2011) argue that investors provide risk capital and therefore by meeting the investors' needs, most of the interests of other groups are simultaneously met. The explanation would be that investors receive the residual value. Hence, the claims of all other groups interested in the company's performance e.g. debtholders, government, managers … must be already satisfied before paying out equity e.g. in form of dividends. Thus, the IASB focuses on the investor's interest in useful information for making an investment decision. Additionally, it is important to note whether the decision maker would prefer conservative or neutral information.

However, focusing on investors' interests does not automatically imply that every individual in that pool has the same interest e.g. different judgements and estimations, time horizons or risk aversions. Thus, a uniform pool of requirements is impossible to create and therefore compromises have to be accepted. Information may be essential and even may facilitate decisions about purchasing, holding or selling a company's shares. This significantly highlights the focus on the company's future performance. Assessing a company's future performance or financial development brings along a certain degree of uncertainty. This leads to judgements and estimations which have to be done. Neutrality represents a substantial attribute in the IASB's Conceptual Framework. Nevertheless, it could be seen as

[90] Cf. FASB (2015), Investors: Help us to improve Financial Reporting.
[91] Cf. Kothari/Barone (2011), p. 40.

doubtful that the financial statements of a company's performance would always provide the objective perspectives that are basically desired.[92]

Biased Information

The use of accounting principles emphasises the possibility of consistency in reporting between firms and, additionally, over different time periods of the same firm. Further, it has made accounting standards uniform to minimise the manager's options to manipulate financial statement information. Especially the IASB asks for principles which should cover possible lack of regulation to mitigate against increasing freedom of choice and accounting flexibility.[93]

Deegan/Unerman (2005, p. 184–187) discuss whether the possibility even exists to provide neutral and unbiased accounts of a business' performance and position. Most experts come to the conclusion that firms are able to bias information by understating or overstating true conditions. Conservatism is connected to understatements of financial reports. Firms applying conservative accounting may aim to report bad information with the consequence of low asset value or low cash flow. [94]

Basu (1997) and Watts (2003a) examine accounting conservatism in terms of differential verifiability standards that must be met for measuring and including good news and bad news in reports.[95] Thus, good or bad news represents information of accounting reports. Conservatism is a continuing issue for those reports and experts argue that both good and bad information are a big issue for accounting.

Bias on the one hand, may occur when accounting systems have a consequent tendency or principle to prefer one outcome over the other. Examples could be conservative cultural fear of litigation costs or prudent leadership. Conservatism is applied as a common principle to that particular accounting process. Whereas on the other hand, biased information may also

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[92] Cf. Deegan/Unerman (2005), p. 184.
[93] Cf. e.g. Palepu/Healy (2013); Pellens et al. (2014), Wagenhofer (2005); Zülch/Hendler (2015).
[94] Cf. Gigler/Hemmer (2001), p. 471.
[95] Cf. Gigler/Hemmer (2001), p. 472.

be a result of the management preparing financial statements under circumstances or conditions which can misstate true conditions.

Palepu/Healy (2013) cite a statement from an investment banker which states that there will be no use of conservatism anymore, if the delegation of reporting is given to independent auditors. Thus, voices are heard more loudly that financial accounting should be based on the work of professional auditors. Many ask for financial accounting based on professional auditors and it is assumed that there actually are professional auditors. However, Deegan/Unerman's (2005) position is that this does not automatically imply that audits are also based on professional judgements. External auditing provides support to ensure compliance and integrity with financial statements, and thus to ensure that managers keep to the accounting rules and principles.[96]

Ball (2001) states two essential criteria for efficient financial reporting systems:

- Independence from managers.
- Timely incorporation of economic losses.

Firstly, accounting practices determine the types of disclosures and secondly, understanding accounting allows the user to use the disclosed financial information effectively. Respectively, for the auditor it can be seen as a tool to communicate their performance to investors and other interested groups. Palepu/Healy (2013) examine two essential steps in the process of accounting analysis for the auditing management but also for investors:

1. The awareness of the key success factors and risks, reflected in the financial statement.
2. The evaluation of the management’s judgement, reflected in the critical financial statements items.

[96] Cf. Palepu/Healy (2013), (part 2) p. 9-16.

From the investor's point of view the purpose of accounting analysis is to use financial data in order to assess and evaluate a company's past and also future performance. The understanding of the accounting process and further financial figures and numbers, provides the chance to obtain an insight into the company. The importance of identifying the accounting flexibility should be highlighted for investors. Accounting flexibility may lead to accounting distortions and bias. Because of this, there is a tendency for users of financial statements to evaluate the degree to which a company's accounting captures its underlying business reality. The desired next step would be to reverse the distortions. Hence, accounting analysis would enhance the reliability of financial analysis conclusions. [97] Wagenhofer/Ewert (2015) assume that in an efficient capital market, there would be no concern about distortions as the user of the information would be able to identify the bias.

[97] Cf. Palepu/Healy (2013), (Part 2), p. 1.

5.2.1 Investors' Aim for Conservative Accounting

"Investors are more concerned about Downside Risk than Upside Potential […] prudence helps to address this concern."[98]

THE HUMAN BEHAVIOURAL DECISION MAKING PROCESS UNDER UNCERTAINTY

"Humans react more sensitively to gains than losses."[99]

Based on empirical studies investigated and first published as the *Prospect Theory* by Kahneman/Tversky (1979), it is proposed that the decision processes differentiate between losses and gains. The interpretation of conservatism and the interest in more downside risks than gains may be explained by the prospect theory. People naturally weigh losses more heavily than gains in a decision process. The theory is a behavioural economic theory and the research is designed to investigate the decision making process under uncertainty. This could be adopted correspondingly for making decisions and judgments in accounting and investing under uncertainty. The theory focuses on the choice of the alternative made by rational people, considering the risks when the probabilities of the outcomes are known. The results show that the decision is made by assessing the potential value of losses and gains and not the actual outcome. Losses are argued to hurt more than gains could. This is also described as loss aversion.[100]

Notwithstanding, it differs significantly from the expected utility theory, which considers the rational agent to be indifferent and only concerned with receiving absolute wealth. However, the prospect theory can be supported by the argument that investors tend to be more interested in losses than gains. The consequence of conservatism is that losses are given more weight and in this case, it certainly helps to address this concern. Considering an efficient capital market, distortions of conservatism may not lead to a change or a loss of

[98] IASB (2015a), p. 20.
[99] Commonly and personally assumed hypothesis.
[100] Cf. Kahneman/Tversky (1979).

investor’s benefits. As rational investors get the information of distortion and are aware of it, conservatism does not affect their decision.[101]

In contrast, according to the equity holder’s limited liability, investors are merely responsible for the share on equity they are holding. The further argument would be that they anticipate losses limited to their investment but profit from limitless gains. Debt holders in turn, anticipate losses but do not anticipate profits which exceed the agreed sum of return. Thus, equity holders are liable only for their share and receive a portion of losses and gains in relation to their share. Neutrality therefore should provide information assessed equally and without bias so that information is available for all individual needs.[102]

INVESTORS’ REASONS FOR THE AIM OF CONSERVATIVE ACCOUNTING

Many investors argue in favour of including a conservative bias in the recognition or measurement in financial statements. Investors may consider the consequences of conservative measurements in reports which comprise:[103]

- A determination of the dividend pay-out policy.
- The business capitalisation and reserves for possible future losses.
- Payments and compensation contracts to the management and further rewards and bonus systems.

For these consequences, it is argued that there may exist an asymmetry if the emphasis lies either on overstatements or understatements. Wagenhofer/Ewert (2015) explain that investors who have provided capital share an asymmetric part of the business’ success. For that reason, the principle of *Going Concern* could be eminently desirable. One essential investor’s risk may be the business’ insolvency. Therefore, of considerable interest would be the minimum level of the asset’s value to cover all debts in case of insolvency and to receive

[101] Cf. Wagenhofer/Ewert (2015).
[102] Cf. e.g. Smith/Watts (1992).
[103] Cf. Cooper (2015), IFRS investor perspective: A tale of prudence.

a residual value. Conservatism would support this interest by the tendency to understate assets and overstate liabilities.[104]

Dividend pay-out policy vs. capital raise is a good example of this. Cooper (2015), a member of the IAS board, argues that it would be significantly harder to raise additional equity capital compared to paying out dividends. Thus, an undercapitalisation as a result of dividend pay-outs may be much more difficult to compensate compared with deciding to retain dividends. It is further assumed that an undercapitalisation and possible bankruptcy may lead to more harm than an overcapitalisation, even if it did not lead to an optimal utility result. Hence, it would also have an impact on the rate of return for investors.

To find a solution to achieving an optimal outcome appears to be extremely challenging. Taking the prior arguments into consideration, conservatism could be a solution to prevent further undercapitalisation and dividend pay-out policies which are too loose and too easy. However, the question arises if conservatism in fact should be of concern to dividend pay-out policies in order to achieve an optimal distribution for investors and also the business itself. Further, for critics the argument arises that conservative accounting should not play a significant role in adequate capitalisation.[105]

Conservatism is often found in industries with a high degree of information asymmetry as well as in industries with relatively low ex-ante profitability. LaFond/Watts (2008) suggest that information asymmetry results in increased timeliness in the recognition of bad news compared to good news. As an example for asymmetric information, research and development (R & D) is often explained in literature. Investments in tangible assets are capitalised under U.S. GAAP and IFRS. Intellectual property is capitalised under U.S. GAAP only for certain self-generated software assets and for purchased intellectual property. Treatment of intellectual property under IFRS deviates from U.S. GAAP. Development costs in comparison to research costs can be capitalised under specific conditions.[106] That means even if there are assumed possible future cash flows flowing into the business, it is mostly not recognised. This should be the result of the approach on investor's protection.

[104] Cf. Wagenhofer/Ewert (2015).
[105] Cf. Cooper (2015), IFRS investor perspective: A tale of prudence.
[106] Cf. Smith (2010).

5.2.2 Investors' Aim for Neutral Accounting

"*For investors using financial statements to make decisions on their investment, any deliberate over- or under-statement is likely to lead to suboptimal decisions and a misallocation of capital."*[107]

The IASB again explain that neutrality should not lead to any bias which should basically allow neither an overstatement nor an understatement of assets and liabilities. Thus, their main aim is to make clear that it should not only be a remedy against negative biases but also avoid optimistic biases, as neutrality is subjected to faithful presentation without biased information. Conservatism in turn could lead to a pessimistic assessment which may result in misstated information.

FAIR VALUE AS A MEANS OF ACHIEVING NEUTRALITY

An approach to neutrality may be the use of fair value measurements. Fair value would serve investors with information in bad and good situations to provide a faithful presentation. Good information as well as bad information should be equally reported to provide full information. Thus, an investor should have the possibility of being informed about good and bad news promptly.

Fair values are mostly applied to financial assets or liabilities.[108] Fair value accounting is a concept to measure assets and liabilities. It is described by the IFRS 13 as *"[…] the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."*[109]

The fair value is designed to determine the value at market basis instead of the entity's-specific orientation. The objective is to assess an asset's price at a level someone would be willing to pay for it and to assess a liability's price which could be settled on the market. If an active market assessment is possible, the IFRS asks for the application of the fair value (level 1 or otherwise it refers to level 2 and level 3 measurement including mark-to-model

[107] Cooper (2015), p.1.
[108] Cf. Laux/Leuz (2009).
[109] IASB (2010), Conceptual Framework.

assumptions) and, additionally, disclosures about fair value measurements are required. The fair value measurement concept could be seen as somewhat controversial to the approach of conservatism as it refers to the consideration of the *most advantageous market.* This is defined by the market that assesses the highest price someone would pay for the asset and the minimum price someone would accept for the liability.[110]

Fair values are argued to be used mostly for financial assets and liabilities. Opponents point out that the harmonisation of the characteristics of relevance and reliability may be harmed by the fair value approach. As the fair value measurement results from current market measurements, it should reflect the true underlying value. Market prices are suggested to arise from individual expectations about the firm value. In addition this firm value or goodwill includes the value the capital market believes the business is worth. Thus, it is not measured on the basis of asset value but on the price someone would be willing to pay. This may often differ drastically from the asset value. For example it deviates in R & D and goodwill considerations. Goodwill is often also described as an intangible asset and, if not derivatively purchased, not allowed to be recognised by the IFRS. In contrast, the measurement on historical costs represents a past event which has evidently taken place and is not merely assessed by the market valuation and development. Fair value is based on assumptions and especially in case of no availability of an active market, those assumptions may lead to an arbitrary valuation of the assets and liabilities. This brings along a mitigation of the reliability of the measurement; particularly for non-financial assets, internally produced or customised. This approximation may also cause substantial biases and distortions. Thus, there are some clarification regulations in the IFRS, stating some items that can be measured at fair values and the others at historical costs. [111]

Fair value is discussed to represent investor's interests. On the one hand, proponents claim fair values as a reflection of the current market situations in order to receive timely information and simultaneously achieve transparency and good market regulations. On the other hand, contrary views point out that fair value cannot comply with the requirement of relevance and present a misleading value of long-term assets and especially assets that are

[110] Cf. IAS (2010), IFRS 13.
[111] Cf. Barth/Landsman (1995); Laux/Leuz (2009); Wagenhofer/Ewert (2015).

held to maturity. Further, opponents discuss consequences of distortions because of market inefficiencies and investor's irrationality or liquidity problems.[112] Taking into consideration that market reactions may be temporary because of sudden shocks which increases or decreases stock prices drastically for a short period or speculation intents on market developments. This leads to fair value prices being temporarily distorted because of their sensitivity to capital market reactions. Hence, it may not reflect true underlying conditions and would also no longer unbiased.

Laux/Leuz (2009) debate on the investors interests in current values of financial assets and liabilities, even if they hold them until maturity. This could result from their aim to assess past decisions under current conditions or to decide on an exit option, for example for loans. Furthermore, banks possess capital requirements which are expected to be favoured not only on the basis of expected future losses at the time of transaction but also when those expectations change.[113] In contrast, the realisation of the profit the first time the asset is sold may provide an incentive to sell or hold the asset even longer than would be rational for the project.[114]

Considering an efficient capital market, distortions of conservatism may not lead to a change or a loss of investor's benefits. As rational investors get the information of distortion and are aware of it, conservatism is not affected by it or at least considered by them when making their decision. Nevertheless, it affects the price sensitivity and causes therefore a loss of information compared to neutral, unbiased information.[115]

[112] Cf. Laux/Leuz (2009), p. 826–828.
[113] Cf. Laux/Leuz (2009), p. 828.
[114] Cf. e.g. Landsman (2006).
[115] Cf. Wagenhofer/Ewert (2015), p. 159.

5.4 Asymmetric Information between Firm Insiders and Outsiders

Various factors influence the quality of accounting-based financial reports. The primary aim is to provide a faithful presentation of the company's performance based on relevant information in accounting figures and financial reports. Managers are mostly responsible for providing that information and it is assumed that they possess discretion in accounting choices.[116] Thus, this perspective and further incentives for the management of financial reporting items have also to be considered.

5.4.1 Moral Hazard and Adverse Selection as Part of Economic Information

Manager's insider knowledge is claimed to be on the one hand, a source of valuation and on the other hand, a source of distortion in accounting data. Therefore, it can be challenging for external users of financial statements to separate information from distortion and noise.[117] Watts (2003a) points out that as long as information asymmetries exist in reporting which affect management's welfare or/and potential investor's asset allocation, biases and noises leading to moral hazard will be a big concern.

The delegation of reporting to management covers costs and benefits. It is the management's responsibility to apply accounting principles. On the one hand, accounting rules and auditing have evolved to unify information and decrease costs and on the other hand to maintain the vantage of delegating financial reporting to corporate managers. Corporate Governance approaches or the Sarbanes-Oxley Act[118] in the US increases the involvement of the top managers with financial reports as a way of decreasing the costs of this delegation.

Kwon et al. (2001) define conservatism in a manager-owner moral hazard model, whereas other theories analyse that litigation costs and the adverse selection problem of the debt market should be derived from conservatism.[119] Watts (2003a) highlights debt contracting as the primary explanation for accounting conservatism. However, financial reports depend on

[116] Cf. Palepu/Healy (2013).
[117] Cf. Palepu/Healy (2013), (part1), p. 10-11.
[118] The Sarbanes-Oxley Act is a regulation in the USA of corporate governance and financial practice.
[119] Cf. Wang et. al. (2009), p.38.

a manager's decision to issue disclosures, financial reports and further information. Therefore, managers are offered incentives to either report more or less conservative i.e. more or less timeliness. Mora/Walker (2014) debate that conservatism does not automatically imply that information is biased. They further suggest that in case of managers having information which challenges conservatism and cause an understatement of a true and better performance, they would have an incentive to correct the bias by a voluntary disclosure.

Basu (1997) and many other experts rank financial reports according to the degree of conservatism.[120] Gigler/Hemmer (2001) argue that the more conservative the manager reports, the lower the risk-sharing profit of timely disclosure and the less valuable voluntary disclosures are to the manager. Little evidence is provided for the argument that changing the properties of financial statements implies a change of other sources of information.[121]

Conservatism can be seen positively in one aspect as it helps to eliminate negative projects with a too optimistic forecast of cash flow. It could serve as a timely signal of a company's dead project and could generate further useful information.[122]

Mora/Walker (2014) discuss that notions of adverse selection and moral hazard, which significantly underlie economic information, seem to be missing in the Conceptual Framework. The IASB and FASB contribute to the explanation that contracting benefits tend to be the private concern of the contracting parties.[123]

The IASB and the FASB represent the view that useful accounting information should be neutral and therefore reject conservatism in accounting systems. Barker/McGeachin (2015) debate the recent financial crisis as a consequence of overruling moral hazard in financial reports. The point of view of Barker/McGeachin (2015) is that the standard setters should have been taught the importance of existing moral hazards and that the IASB should take moral hazard into account.

[120]Cf. Ball et. al. (2000) and Bushman et. al. (1999).
[121] Cf. Gigler/Hemmer (2001), p. 474–477.
[122] Cf. Watts (2003a).
[123] Cf. Wagenhofer/Göx (2009).

García et al. (2011) argue that accounting choices are about potential wealth. This indicates that good firms transfer proclivity to be a good firm and explore implications of an adverse selection into the relation between conservative accounting and efficiency of debt contracts.

Arguments show that a clear conclusion cannot be made for the hypothesis that conservatism is always an advantage for the investor and is only for an investor's protection. It depends on the point of view. Conservatism is not the only factor that influences the outcome and the solution to these conflicts and cannot generally solve the problem of information asymmetry. It is more important to consider conservatism in relation to covenants, restrictions, conditions and projects.

5.4.2 Effects of Investment Policies and Covenants

Lots of theories and studies try to provide evidence for the argument that conservatism supports investors, whereas others try to corroborate hypotheses stating the opposite. Several studies illustrate the opposite effect, namely conservatism mitigating overinvestment or even animating underinvestment caused by uncertainty.[124] These results can be explained by starting from the management's point of view. When managers are short-term focused, they may omit a positive investment project because of cost-intensive financing at the beginning and unwillingness to consider the generated profits in the future. Roychowdhury (2010) also assumes that profitable projects bearing lots of risks, are not being realised because of the management's risk aversion. Balakrishnan et al. (2015) contribute to the explanation that conservatism supports the investment caused by this uncertainty about future profits. It is suggested therefore that conservative accounting, provides a signal for considering risks, by recognising losses earlier and profits only when there is sufficient evidence.[125]

The asymmetric allocation of profits and losses for debt holders could be seen as the source of the problem. In the case of operational losses and insufficient capital to cover those losses, debt holders are caused to anticipate those losses. This implies that they do not receive the agreed sum of return in the case of a company being unable to pay back and also

[124] Cf. e.g. Ball (2001) and Bushman et al. (2011).
[125] Cf. Watts (2003a).

having to bear the company's losses. Whereas, in the case of operational profits and sufficient liquidity to pay back debts, debt holders merely receive the agreed return. Thus, debt holders anticipate losses but, in contrast, do not anticipate profits which exceed the agreed sum of return. In comparison, equity holders including their limited liability being not personally liable but, only for their share, anticipate both profits and losses.[126] A way to prevent debt holders from the transfer of wealth to equity holders e.g. dividend policies and investments with reallocating risks, debt contracts or so called covenants are introduced.[127]

Debt contracts as an impact on financial reporting and investment, in reference to the standard setters, appear to be extremely challenging. The IASB and FASB state that contracting benefits tends to be the private concern of the contracting parties which may be biased by covenants and the use of appropriate adjustments to financial statement information. Academic experts urge accounting standard setters to consider the fact that ex-ante resource allocation stands in relation to those contracts and biased information.[128] To perceive an undistorted view of the situation, it would be important to do ex-ante research before contracts are signed.

Nevertheless, a general purpose of the objectives would also be efficient capital allocation. This could be achieved by financial reporting which also includes the perspective of contracting. Barker/McGeachin (2015, p. 11) even suggest, "*[…] the objective of providing decision-useful information to investors should not be presumed, in an agency setting, to imply that the 'unbiased' reporting of net asset values is realistic or desirable*." Investors may have a common interest in conservative general purpose statements, as they may all have agreed to similar contractual settings.[129]

Borrowers are obliged to present positive repayments prospects in order to signal their ability to pay back agreed returns and further, mitigate the lender's uncertainty. This could be done by reducing information asymmetries and providing more information than actually necessary. Additionally, a mean to signal a positive type could be to provide internal private

[126] Cf. e.g. Smith/Watts (1992); Bushman et al. (2011); Kothari et al. (1988).
[127] Cf. Smith/Warner (1979).
[128] Cf. Göx/Wagenhofer (2009), p.2.
[129] Cf. Barker/McGeachin (2015).

information. However, this only makes sense if there are sufficient other institutions being bad types and also seeking finance.[130] Signalling the type plays a significant role in these systems. Decisions are made as a consequence of signals which imply that signals have to be interpreted carefully.

The following section examines a model with the assumption that the capital for an investment is always raised by external lenders and the net present value is always positive. The model can be shown in a principal-agent conflict. It states that the manager's actions increase the likelihood of a future desirable event. According to Gigler/Hemmer (2001), those actions are a consequence of the transactions the accounting system first records and then, at a predetermined time, aggregates and releases to the public as a part of the firm's financial report. So, the principal ex ante sets up a level of conservatism and the cash flow x can be either high x_H or low x_L where $0 > x_L > x_H$. Neither x nor the environmental situation is ex-ante observable. Therefore, the principal relies on the signal y provided by the information from disclosures in financial reports. The manager takes over the responsibility of this signal. Thus, if the principal urges the manager through covenants to report conservatively, y_H is less likely to be reported because of the higher probability of y_L, but it implies also more information content and accuracy.[131] This would ensure the principal's aim of being more certain about future profits. Not forgetting the fact that information is costly, all covenants and contracts include costs. However, the manager and the principal have to consider their individual cost of information. The manager would accept more restrictions and covenants only if the principal pays compensation for it. This leads to the adverse selection model where the principal defines a predetermined covenant comprising the favoured risk attitudes. The result would be that only the manager the principal is looking for would accept the restrictions in that covenant.

With the possibility of p the good situation occurs and the cash flow x is with a possibility of q higher than 0; or with the possibility of $1 - \mathrm{q} = 0$. Respectively, the assumption is the possibility of $1 - \mathrm{q}$, which has the effect of a bad situation and the cash flow $\mathrm{x} = 0$. Hence, the expected value is $E\ (x) = q * \mathrm{p} * x$ and $E\ (x)$ is higher than I , which makes the net

[130] Cf. Callen et al. (2011).
[131] Cf. Wagenhofer/Ewert (2015).

present value always positive and theoretically favourable. It is assumed that payback d is always covered by the cash flow. Hence, the pay back d must be greater than the initial investment I ($\mathrm{d} > I$) and I has to be covered by x the cash flow which therefore has to be greater than d ($\mathrm{x} > d$).

The question is, whether the investment should be liquidated or continued. The decision depends on the signal. y_H would be the signal for continuation and by contrast the bad signal y_L would lead to liquidation of the investment. After the investment has taken place, the manager perceives a signal from the accounting system, which includes incomplete information about the cash flow.

$$\Pr(x/y_H): x_H > L = continuation$$

$$\Pr(x/y_L): x_L < L = liquidation$$

The rational decisions would be that in case of a high cash flow x_H the investment project should lead to a continuation, whereas with the occurrence of the low cash flow x_L it should be liquidated. In case of liquidation: L, the liquidation value is always positive ($\mathrm{L} > 0$) but the investment was greater than the liquidation value $\mathrm{I} > L$ thus, $\mathrm{p} * \mathrm{d} < L$. It is assumed that the manager always profits with a positive non-monetary utility from continuation e.g. experience. This is not the case for the debt holder and thus, the decision is accompanied by a conflict of interests:

- The manager aims to continue because this would imply a positive utility for him, whereas in case of liquidation his utility would be 0.

- The lender wants to liquidate the investment because in this case he gets the profit of liquidation ($p * d$) whereas otherwise he might end up with nothing.

The neutral decision based on the equally probable cash flow would depend on the signal, good y_H or bad y_L. As the manager is the active operator and wants to continue the investment project, he urges for the outcome of a positive signal y_H.

A possible solution would be a covenant stating that in case of signal y_L the manager can decide whether to forgo the investment and in case of y_H it is the lender's choice. However, this covenant would solve only part of the problem; the problem of error terms still exists. There might be four possible situations. Two, where the signal leads to the correct cash flow and therefore to the optimal choice over the decision of continuing or liquidation. The other two situations would be misleading situations which lead to *type I* and *type II error* terms.

- *type I error* (with probability f_H): Signal y_L but nevertheless a good environmental situation x_H - the investment project would be wrongly liquidated even if it would be profitable to continue.

- *type II error* (with probability f_L): Signal y_H but nevertheless a bad environmental situation x_L– the investment project would be wrongly continued even if it would be unprofitable.[132]

Type I error might lead to a significantly higher loss whereas *type II error* might be in an acceptable scope of loss. The optimal accounting system therefore would be if f_L is kept low and f_H high. Thus, if $f_H = 1$, the accuracy of signal y_L is effectively increased and it is not probable that the investment project would be liquidated. This leads to the result that the optimal system urges for a low level of conservatism.[133] Conservative accounting would be achieved by a settlement of the probabilities of error terms. The optimal accounting system would be to urge for a rather low level of f_{L}, and by contrast a high level of f_H. To decrease *type I errors*, more projects are being continued. Conservatism would therefore not support debt holders. This favours rather no conservatism and the emphasis on neutrality would be enhanced for debt holders. Wagenhofer/Ewert (2015) or Gigler et al. (2009) suggest keeping the probability of y_L $\Pr(x/y_L)$ as low as possible by urging $f_H = 1$ and therefore y_L is as accurate as possible. Chen/Deng (2010) outline that signalling via conservatism leads to higher *type I errors* but higher *type II errors* compared to debt covenants serving as a signalling device.

[132] Cf. Wagenhofer/Ewert (2015), p. 174.
[133] Cf. Wagenhofer/Ewert (2015), p. 174.

A further attempt to reduce information asymmetries is the consideration of renegotiation of contracts. As the manager has full information, he/she will have more information if the project generates future profits. Consequently, if the manager receives a good signal to continue, he/she will not be willing to pay back the loan in the current period but is willing to sign a contract, stating to pay back a higher rate of return than the initial agreed one. This will provide the lender, as the worse informed member of the project, the essential signal y_H that the project will generate higher future profits and simultaneously partially covers the lack of information asymmetry. Thus, the result will be that the lender accepts to continue the project.[134]

Conservatism could be used by debtors or managers signalling their proclivity to adequately meet investors` or debtors` aims in order to maximise pay offs. Watts (2003b) describes the demand of conservatism for debt contracts, whereas Callen et al. (2011) revise this assumption and discuss the connection between covenants and conservatism which may be understated and caused more by high information asymmetry. Experts try to illustrate that conservative accounting is a complement to high information asymmetry, but has no impact in a low asymmetry information system.

Moreover, incentives could be an important instrument for lenders to prevail upon the manager to report conservatively to attain a signal $y_{L.}$ Callen et al. (2011) examine that an environment with high information asymmetry in which lenders are more uncertain about debtors` proclivity, it may be more essential to consider the investor’s wealth. Good firms with lower agency conflicts tend to signal their type via conservatism in order to reduce borrowing costs in relation to bad firms with higher agency costs. The model is designed to analyse whether more costs of debt under high information asymmetry can be reduced by more conservative accounting and reporting combined with more covenants. [135]

Conservatism may also support lenders because it expedites debt covenant violation and provides a timelier signal of default risk.[136] Therefore, Ahmed et al. (2002) and Zhang (2008) suggest that capital providers will reward conservatism by reducing high interest costs.

[134] Cf. e.g. Gigler et al. (2009); LI (2010).
[135] Cf. Callen et al. (2011).
[136] Cf. Zhang (2008), p.28.

According to these considerations, conservatism lowers covenants while by contrast, other experts explain that they are complements.

Under conditions of high information asymmetry, high interest will be charged. This could generate an incentive for the management to induce good signals to reduce those costs. Signals are always related to costs. Managers therefore have to consider and compare the costs of signalling, information procurement and their opportunity costs. To decrease costs of signalling, covenants need to be restrictive. Covenants are indeed restrictive and further reduce the manager's possibility to choose the level of conservatism. Conservative accounting can face more costs but the choice of the level of conservatism could send a signal as to whether the manager is a good or a bad type. To signal good performance and the genuine ability to pay back returns, it would be desirable for good type management to reveal themselves as good type managers, to distinguish them from the bad type. Bad type management could accept the offer of a combination of costly conservative accounting and covenant signals.[137] Results indicate that it would be optimal for companies with underlying low risk to choose a high level of conservatism and controversy and companies under high risk to choose no conservatism.[138]

Callen et al. (2011) analyse that a combination of signalling through conservatism and restrictive covenants might be an efficient solution. This reveals the good type and costs can be kept as low as possible. The investigation concerns information asymmetry, with the lender being not fully informed about the borrower's willingness to comply with the lender's wealth requirements. The results show that under conditions with high information asymmetry, conservatism and covenants might be complements to signal the borrower being a good type and fulfil the lender's demands.[139] Good firms with lower agency conflicts tend more to signal their type through conservatism minimise interest rates. Under a high level of conservatism and additionally restrictive covenants, lower rates of interest can be considered. Callen et al. (2011) further find that this might also imply that those borrowers will not be so likely to transfer future wealth from creditors to equity holders. Price

[137] Cf. Callen et al. (2011).
[138] Cf. Wang et al. (2009).
[139] Callen et al. (2011), p. 1.

protection might be considered by the lender setting up an ex-ante high level of interest and accounting conservatism.[140]

In low information asymmetry, the problem would not arise because the good type could signal it by involving high costs occurring from a high level of conservatism and lower restrictive covenants. Conservatism under this approach supports the bad type and leads to a rise in information asymmetry because of weak incentives for good types to give information about their good performance. Moreover, the good type manager could accept not to compensate the information asymmetry involving high costs and could choose to pool with the bad types.[141]

Conservatism in literature suggests higher verification standards required for profits in contrast to losses. Conservatism, in the absence of private information can result in a high rejection rate for positive net present value projects and the overall surplus will be reduced. Conservatism increases the ability of good firms to mark themselves off from bad firms in order to prevent failures in the capital market. Bushman et al. (2011) present an examination, where a business of good or bad type seeks financing for a new project. A binary accounting signal, low or high, increases efficiency. The signal can be recognised before financing and investment like a report which gives information inside the firm's ability to generate positive expected value projects. In this setting conservatism could be the inverse of the verification standard of bad news. Consequently, the signal is more conservative in cases of lower verified standards. Thus, conservatism can be considered as useful when the investment is ex-ante not profitable. Conservatism could be seen as desirable in order to improve the feasibility of a marginal investment opportunity. This could restrict the role of conservatism in real economy. [142]

Under the model's considerations, the signal is released before the investment is done and it can be interpreted as a general signal of the underlying technology of the firm. Hence, good firms aim to present their performance to markets. Despite the potential reduction of overall informativeness of the reporting system, conservatism increases the reliability of a high

[140] Cf. Chen/Deng (2010), p. 5.
[141] Cf. Callen et. al. (2011), p.6.
[142] Cf. Callen et al. (2011).

signal. The existence of the high signal is often a necessary, but not a sufficient condition for receiving financing. Roychowdhury (2010) refers to a study from Francis/Martin (2010) which is designed to find out if conservatism leads to improved acquisition decisions of managers. The paper suggests that the discussed correlation between conservatism and future investments may be potentially imperfect. However, results show that conservatism leads to better investment decisions.

5.5 Management's Perspective on Conservatism vs. Neutrality

5.5.1 Management's Natural Bias Towards Optimism

Business performance is generally measured by financial statements and accounting figures. The reported profit often builds the basis for a management's bonus and rewards. Thus, the results of these reports may have a notable influence on the management's compensation, career and reputation. This could be a significant incentive for management to adopt accounting policies which present higher profits and higher asset values. Consequently, this may lead to overstatements and further, the possibility of earnings management increases notably and, optimal work force may not be ensured.[143] Watts (2003a) mentions managerial compensation contracts as a source which produces conservatism. He discusses contracting as an efficient method used for the organisation of contracts i.e. conservatism is the contracting mechanism.

Firstly, considering the timeliness explanation of conservatism, employing a manager with a focus on short term success, more recognised profits and less recognised losses would suggest a huge bonus for the manager.[144] Secondly, it could be seen critically that cash flow based compensation can be verified. Thirdly, Watts (2003a) and many others point out that management is provided with incentives to hide losses in order to protect their employment and further bonuses.

Numerous accounting conventions have been introduced to ensure that managers use their knowledge and responsibility to provide a business report based on reality and prevent them from working for their own interest. Conservatism for that reason could represent the answer to "manager's potentially optimistic bias". This in turn should not mean that conservative accounting is "good" accounting. The focus should be primarily on capturing the reality of the business without any bias or influence. [145]

[143] Cf. Wagenhofer/Ewert (2015).
[144] Cf. Watts (2003a).
[145] Cf. Palepu/Healy (2013), p. 6.

To elaborate on a prior model, according to Callen et al. (2011), two types of firms are considered: Good firms with a current value E_H and bad firms with a current value E_L, where $E_H > E_L$.

Both firms are presented with an investment opportunity but are unable to raise internal capital to finance those projects. Therefore, they are both looking for a risk-neutral equity investor. The good firm will realise a cash flow of x_H for an investment of $\mathrm{x} > 0$; the bad firm will realise a cash flow of $x_{L.}$ The investor asks for a return r_e.

If the good firm can get finance for the investment project, the face value would be $E_H + x_{H,}$ whereas if the bad firm gets financed in order to realise the investment, the terminal value would be $E_L + x_L$.

Both good firms and bad firms are in a position to release a high signal with the probability $\Pr(y_H) = q * f_H + (1 - q) * (1 - f_L)_.$ Including conservatism c the probability of a good signal would be $[1 - \mathrm{c} + \mathrm{q} * (1 - \mathrm{c})]$, or otherwise a low signal. In the case that conservatism is at its maximum level $(\mathrm{c} = 1)$ only good firms are able to generate a high signal to the potential investor. At the minimum level of conservatism $(\mathrm{c} = \mathrm{q})$, exclusively bad firms generate a low signal. Therefore, conservatism leads to an increase in the usefulness of information of the high signal and a decrease in the usefulness of information of the low signal.

It is debatable whether these consequences support the investors' interest. In the case of facing grave liquidity problems, the management could try to present a better image of the business. As discussed before, lower asset values in the case of liquidity problems through understating assets may be favourable for equity holders. Moreover, optimistic estimations and a tendency to overstate would on the one hand, protect from the negative consequences of presenting poor performance and on the other hand, in good years with very high profits, no reserves would be withheld to cover possible future losses.

Conservatism could prevent these serious negative consequences and limit the scope of managing' earnings to higher levels than they are. Further, the early recognition of possible future losses may influence the management's investment decisions. This happens especially in the case of different time horizons of the investor providing capital to the company and the further investment for the company itself. [146]

The principle of neutrality would in turn suffer under the application of conservatism. However, neutrality which is designed to eliminate bias could also ensure avoidance of over-optimistic management behaviours. A rational mindset plays a key role when measures of judgement and estimations are required. The IESBA[147] under paragraph 290.6 outline that, "*The state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional scepticism."* Thus, it is essential to include rationality in all judgements. As the IESBA requires the application of the "Conceptual Framework approach" to determine their compliance with fundamental principles whenever they know that circumstances or relationships may compromise their compliance,[148] a further paragraph (120.2 IESBA) supports the principle of neutrality, saying that "A professional accountant shall not perform a professional service if a circumstance or relationship biases or unduly influences the accountant's professional judgment with respect to that service".

Neutrality should reflect the true conditions and it should also support the avoidance of earnings management because of optimistic management bias. Henselmann (2008, p. 58–60) recomends the need for neutrality as key to ensuring that that the management or the business itself does not work in their own interest.

5.5.2 Earnings Management

Scandals like Enron, Arthur Andersen and Lehman Brothers, raise doubts about the reliability and neutrality of financial statements. Managers are obliged to make judgments in financial reporting by structuring transactions so that financial statements can be prepared.

[146] Cf. Wagenhofer/Ewert (2015), p. 157.
[147] "*The International Ethics Standards Board for Accountants (IESBA) is an independent standard-setting body that serves the public interest by setting robust, internationally appropriate ethics standards, including auditor independence requirements, for professional accountants worldwide. These are compiled in the Code of Ethics for Professional Accountants"* IFAC-The International Federation of Accountants (2013).
[148] Cf. IFAC-The International Federation of Accountants (2013), para. 100.08.

Incentives to work in their own interests may occur in a broad range. Moreover, possibilities could evolve for managers to apply their authority to manage earnings in a certain direction. Engagement in earnings management causes a bias in financial reporting, inefficiency and further reduces accounting formativeness.

Earnings management may occur in several forms. Firstly, managers may use judgments in financial reporting through structuring transactions to alter financial statements which have already taken place but will reverse in future periods. This would represent the *accrual based earnings management.*[149] Secondly, there is *real earnings management,* where managers could try to misstate true underlying economy conditions to make the performance look more prosperous.[150] Real earnings management influences contractual outcomes which depend on financial statements. Earnings management could be seen as an instrument for managers to achieve specific managerial objectives. In general, the literature provides evidence for a negative association between conservatism and earnings management but some also suggest a positive association. Managers are supposed to tend towards managing earnings in order to increase the short term firm value and/or to meet or even exceed earnings expectations.[151] Thus, it is suggested that conservatism be used to limit a manager's tendency to report optimistic results.[152]

Conservatism in this context seems to represent a positive bias but nevertheless it is a bias Earnings management too, represents a bias. Wagenhofer/Ewert (2011a) raise the question about the assessment of conservatism as a positive bias and earnings management as a negative one. As conservatism is defined as the downward bias, earnings management may be the inverse. The major difference would be the emergence of the bias. As conservatism evolves from accounting standards, earnings management may be the result of an individual's decision. The question arises whether the downward bias may not be seen to be as "bad" as the upward bias. Wagenhofer/Ewert (2011a) contribute to the explanation that earnings management as well as conservatism could decrease the content of information

[149] Cf. e.g. García Lara et al. (2012); Decho et al. (2012); Leuz et al. (2003); Wagenhofer/Ewert (2011a).
[150] Cf. e.g. Decho et al. (2012); Leuz et al. (2003); Wagenhofer/Ewert (2011a).
[151] Cf. Lin et. al. (2014), pp 164-170.
[152] Cf. Ball et al. (2003) and Burgstahler et al. (2006).

but could also be a desirable feature which helps to achieve economic efficiency under certain circumstances.[153]

Leuz et al. (2003) describe earnings management as a conflict between a firm's insiders and outsiders. Existing asymmetries between managers and external investors are claimed to be reduced by conservatism. García Lara et al. (2012) discuss the relationship between conservatism and agency conflicts. Conservatism requires an early recognition of investment decision and therefore managerial agency conflicts may be resolved as managers are unable to defer the consequences to their next generation. As a result of these effects, conservatism should be positively related to investment efficiency. It is also advised to distinguish between firms in terms of their depreciation method. However, not only conservatism prevents earnings management. Issues such as a strong focus on investors' protection, well-developed, stable capital markets and a high degree of legal enforcement are also expected to result in lower earnings management.[154]

Accounting regulations and standards may also provide discretions to managing earnings, e.g. on the free choice of the depreciation method. Firms using accelerated depreciation instead of straight-line depreciation are said to make significantly larger capital investments. Conservatism is assumed to reduce overinvestment as well as underinvestment. Moreover, it should decrease investment among firms with ailing free cash flow problems but respectively, increase investment in firms with financing constraints. An efficient investment policy involves the identification and implementation of all investment opportunities with a positive net present value and rejection of all projects with a negative one.[155]

However, earnings management in a perspective linked to a positive bias could also serve as a source of communication, as the manger could transport additional private information to the public. There would be the chance to receive information about future cash flows which are not realised yet, but which might occur. Thus, information about positive developments

[153] Cf. Wagenhofer/Ewert (2011a), p. 69.
[154] Cf. Leuz et al. (2003).
[155] Cf. García Lara et al. (2012).

may be available earlier and contribute to financial reporting objectives by providing information about the company's performance.[156]

García Lara et al. (2012) point out that a higher level of conservatism reduces the negative effects of information asymmetries. Agency conflicts are argued to be resolved and other sources of information can flourish. Conservatism should limit the possibility of managers to overstate earnings and to be overcompensated under accounting based compensations contracts. Thus, conservatism is assumed to act as a monitoring device which supports the boards of directors and other governance mechanisms to discourage manager's sub-optimal behaviour. Limitations may be generated by conservatism producing early signals. Managers reject investing in *pet* projects and *trophy* acquisitions since they are aware of the monitoring role. Considering these arguments, a strong correlation between conservatism and investment decision and conservatism and earnings management can be observed.[157]

Through conservatism companies are assumed to invest less and outperform other firms in terms of future performance, because they are more efficient in investment decisions.[158] Financial reporting under conservative accounting signals is presumed to encourage more desirable investment behaviour than in firms with less conservative accounting to investors and other shareholders.

According to Wagenhofer/Gao (2014), earnings management, as well as conservatism, cause a bias in the financial report. The manager is able to observe a signal y and has to give a report to the board. Due to financial based compensation, the manager has the incentive to report a signal y_H seen as "good" for the board and therefore they retain the manager. If the manager reports the signal y from the accounting system, it will be costless. If the manager reports a managed signal, it will be costly for the manager personally. The probability of successful earnings management in contrast to the probability of the manager being retained may be lower without earnings management than with earnings management.[159] Only upon y_L board monitoring, conservative accounting is optimal at low cost. Y_H leads to

[156] Cf. Wagenhofer/Ewert (2011a), p. 73–74.
[157] Cf. García Lara et al. (2012).
[158] Cf. Roychowdhury (2010).
[159] Cf. Wagenhofer/Gao (2014).

the result of retaining, so the manager will bias y_L by earnings management. It would be advantageous to control managers through monitoring. However, if the signal is low, earnings management will lead to a reduction of the information content of both signals as well as the benefit of monitoring at y_L. On the one hand, earnings management leads to a smaller landscape in which conservative accounting is optimal. On the other hand, accounting conservatism leads to a lower level of earnings management.[160]

Research results from García Lara et al. (2012) indicate a negative correlation between conservatism and accrual earnings management, whereas those from Decho et al. (2012) show the difficulty of detecting earnings management and therefore, results have to be considered carefully. Wagenhofer/Gao (2014) demonstrate the positive correlation between conservatism and board efficiency as a consequence of, "C*onservatism increases the likelihood of obtaining unfavorable signals relative to favorable signals and, at the same time, it decreases the precision of unfavorable relative to favorable signals."*[161]

Wagenhofer/Ewert (2011a) outline that the standard setters are served with a broad range of possibilities and discretions to apply to earnings management. According to the principle based Conceptual Framework comprising lots of individual judgements, this freedom might give more scope for managing earnings than it would be under rule based standards.[162] Some research outlines the optimal accounting system which is assumed to have no bias, either conservative or optimistic.[163] This would clearly contribute to the IFRS' need for neutrality. Nevertheless, when preparing accounting figures, management has to make decisions including estimations. Those estimations are linked to incentives which could bias the information in financial reports. As it is argued that in most cases complete certainty does not exist, it seems to be impossible to achieve unbiased information as there are always individual judgements that have to be made.[164]

[160] Cf. Wagenhofer/Gao (2014), p. 23–26.
[161] Cf. Wagenhofer/Gao (2014), p. 4.
[162] Cf. Wagenhofer/Ewert (2011a).
[163] Cf. Wagenhofer/Gao (2014), p. 25.
[164] Cf. Kothari/Barone (2011).

BIG BATH AND INCOME SMOOTHING

Another perspective of earnings management that is identified as an accounting problem, refers to managers using their given responsibility to write down assets unreasonably or increase liabilities in order to boost earnings in future periods. Levitt (1998) identifies the big bath as one effect of earnings management. Hanna (2002) outlines this perspective of earnings management, which is to take extraordinary and excessive charges and write offs in one period in order to reach higher earnings in the future. This is described as the so called *big bath*. Deliberately understating assets or overstating liabilities in one period often leads to overstating financial performance in later periods.[165] A big bath process occurs, when extensive losses or write offs have already occurred, and then management adds all other losses, even those from earlier periods, into this period, which then results in a big pool of losses. The consequences would be an extremely poor performance report and possible a decrease of the firm's value for the given period. Following periods, however, can then be brightened by significantly greater earnings. Reserves can be created, described by Watts (2003b) as *cookie jar reserves*. These reserves are assumed to be used for following periods to upgrade compensation, based on earnings or stock prices.[166]

It is also seen, when recognising all losses and writing down net assets that the capital market may react in a positive way. This could be explained by the fact that the market, when observing the assumed slump to the lowest level, may believe that further write offs or losses are less likely. Thus, when it reaches an expected minimum it is assumed to settle up at a realistic level and consequently, higher earnings in the future are more likely to be reported. This may lead to an increase in the firm's value or stock price over the next periods.[167]

A further consideration would be that stock prices are said to be rewarded by steadiness of earnings. Investors often rely on analyst reports and may react to fluctuations of earnings, which can be seen as unsecure. Thus, investor's expectations about future earnings may influence the stock price and further investments. It is assumed that investments are more

[165] Cf. IASB (2013), Discussion Paper.
[166] Cf. Watts (2003b).
[167] Cf. Kasznik/McNichols (2002).

likely to be done, when earnings are not fluctuating erratically. Hence, *income smoothing* may be applied, which is the discretionary use of accounting, to transfer profits from one period into another. This can be reflected as deferring revenues, putting gains into reserves in a good year, in order to compensate for losses in future periods or controversially, a delay in recognising losses.[168]

[168] Cf. Leuz et al. (2003).

5.6 The Role of Conservatism vs. Neutrality in the Financial Crisis

"The financial crisis has demonstrated the need for prudence when making estimates."[169]

The origin of the International Accounting Standards took place with the birth of the U.S. GAAP in the US in the 1930. The U.S. GAAP were founded in response to the stock market crash. Their task was to develop regulations in order to solve the big financial disaster and further, to prevent recurring crashes. In recent times, corporate financial collapses have become a frequent issue in the financial universe. Incorrect accounting figures, inaccurate financial statements and surreal cash flow forecasts are only a few of the errors. Results of these crises are that people's trust has been betrayed and therefore a generation of true and fair presentation of underlying conditions and financial statements represents a significant response to this issue.

Basically, companies facing financial problems or crises are assumed to need a higher level of supervision from capital providers and their activities must be observed more carefully. Thus, managers may be forced to apply more conservative judgments in order to reassure investor's or debtor's fears and doubts. In this case there would even be the demand for this bias. Thus, managerial costs would decrease when being conservative or risk averse.[170]

It is suggested that the financial crisis was caused by overruling moral hazard in financial reports. Managers are assumed to tend to a more optimistic bias, in order to hide bad news and maintain investments and their jobs. As managers are the ones responsible for producing financial reports, the management's perspective plays a significant role in considering the accounting principles. However, standard setters seem to neglect that perspective and argue that it should be a more private concern. Thus, experts urge the Standard Setters to consider the importance of it and that IAS should take moral hazard into account.[171]

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[169] IASB (2015), Basis to Exposure Draft of the CF.
[170] Cf. Alipour et al. (2013).
[171] Cf. Barker/McGeachin (2015).

The last big financial crisis in 2008 has turned the spotlight once again on to fair value accounting. Some argue that fair value accounting could be one of the triggers which led to those consequences, whereas, others contest that fair value accounting has always played a significant role in accounting.[172] Fair value, being one effect which contributed to the financial crisis, is not blamed for not being relevant but, for not fulfilling the criteria of reliability. Most of accounting based research for this issue focussed on financial institutions rather than on businesses themselves and examined whether fair value or accounting discretion led to a bias on bank balance sheets. [173] The results were that the crisis led to widespread differences between an asset's book and market values, especially for US banks. *"As a consequence, discretion over accounting rules combined with regulatory forbearance leads banks to understate balance sheet stresses and to overstate regulatory capital."* [174]

Considering also non-financial institutions, fair value measurements are said to cause cycles in a certain financial period, so called procyclicality of fair value accounting. A downwards spiral may evolve. The use of fair values could lead to asset write-ups, contributing to an extension of the bank's leverage in booms. This could harm financial systems and intensify the effect in a crisis. [175] Because of the rigorous appreciation and increase in value during booms, the reversal and down-writing of asset values may be devastating. In this case, in times of crisis, hidden reserves as a result of conservative accounting practices could be seen as a positive aid. Nevertheless, Laux/Leuz (2009) argue that fair values, as the intent to illustrate market conditions, send warning signals of fear of a crisis which should be received by market participants and even earlier by banks.

Barth (1994) shows that fair values in contrast to historical costs, provide additional information about values which would imply that fair value measurements involve more information content. However, further investigation on fair value losses and gains reflected in the share price leads to controversial results which reduce the reliability of information.

[172]Cf. Laux/Leuz (2009).
[173] Cf. Balakrishnan et al. (2015), p. 1; Huizinga/Laeven (2012).
[174] Cf. Huizinga/Laeven (2012), p. 614.
[175] Cf. Laux/Leuz (2009), p. 829.

The lack of reliability may cause an unfavourable elimination of value relevance and unrealised profits and losses imply a bias and a distortion of asset and liability values.[176]

It is also argued that fair values provide incentives for managers who are interested in short-term accounting earnings, because of possible links to indirect ties. This may lead to inefficient asset sales and possible *contagion effects*. A serious consequence could be *gain tradings* which are characterised by *"[…] selectively selling financial instruments with unrealised gains and keeping those with losses".*[177]

For standard setters the problem may arise to distinguish between serious situations under true circumstances where a market price is misleading and when a manager merely does not want an asset's write down.[178] The application of conservatism would on the one hand, support those possible overstatements but on the other hand, it could lead to further misstatements of financial assets and liabilities. Considering this argument from the standard setters' view, it appears to support the principle of neutrality, referring to no misunderstandings due to biases in order to meet the objective of a true and fair presentation. However, they take no notice of possible internal consequences caused by fair value accounting.

Balakrishnan et al. (2015) examined the effect of financial reporting in the economy during the global financial crisis from 2007 to 2008. They further elaborated on the role of accounting conservatism on firm-level investment during this time. Prior literature research provides evidence that recessional times have brought consequences of underinvestment for businesses because of the decline in investment supplies. Balakrishnan et al. (2015) come to the conclusion that those businesses using a less conservative accounting policy suffer from a more severe decrease in investment activity compared to businesses applying more conservative accounting. This effect is examined for companies that are financially constrained, which means that they need more external finances or underlie greater information asymmetries. Further, they elaborate on conservative companies which are not so extensively affected by decreases in debt raising and stock performance. The results show

[176] Cf. Barth (1994).
[177] Laux/Leuz (2009), p. 830.
[178] Cf. Laux/Leuz (2009), p. 830.

that conservatism indeed reduces underinvestment and underlying information asymmetries. In times of crisis, external capital is limited. Especially under circumstances of uncertainty and further information asymmetry leads to investors' being less willing to provide capital. Information asymmetry between businesses and investors may cause ex-ante adverse selection problems or ex-post moral hazard concerns from private interests. This could even lead to the consequence of investments having a positive net present value not being realised. [179]

Watts (2003a) and other experts[180] discuss conservatism in financial reporting as a means of transporting information that could mitigate those information based problems. As in recessional times, when a company's borrowing capacity is limited and set to a minimum, it is suggested that conservatism may even enhance the ability to borrow. Debt holders experience asymmetric pay offs in relation to net assets. It is suggested that the creditor's aim in this case is to identify, quantify and possibly to reduce the risk of loan defaults. This could be done by being informed promptly about negative events. Thus, debt contracts are introduced, including conservative accounting requirements. Accounting conservatism could be an indicator of negative events or developments, also in the future and it could be further interpreted as a signal that provides investors with information about future cash flows. Restrictions requiring conservatism seem to be essential to ensure the creditor's trust by screening negative events or developments of the company's net assets and further, to control the management's ability to distribute net assets. The results are that businesses, willing to include more conservatism, are rewarded by more capital supply and lower costs of borrowing.[181] Accordingly, companies with a more conservative financial reporting policy are therefore less likely to be underinvested. Moreover, results show that they do not suffer from such a sharp decline in stock prices in times of crisis.[182] Barker/McGeachin (2015) highlights the need for conservative accounting as ex-ante required by investors before signing debt contracts or buying shares. Due to the advised enhancement in borrowing activity, which prevents underinvestment, Balakrishnan et al. (2015) even combine conservatism with value creation.

[179] Cf. Balakrishnan et al. (2015).
[180] Cf. e.g. Armstrong et al. (2014).
[181] Cf. Ahmed et al. (2002) and Zhang (2008).
[182] Cf. Balakrishnan et al. (2015).

6 CONCLUSION

The IASB aim for accounting information that is useful for decisions, to further prepare good quality standards. According to the IASB's Conceptual Framework, decision useful information is characterised by being complete, neutral and free from bias and error. Investors should be able to make their investment decisions based on faithfully presented data. However, this could be seen as a rather vague and non-specific approach.[183]

The IASB has also introduced the *concept of prudence* i.e. conservatism, which has numerous proponents[184] contributing to considerable arguments. However, the implementation of conservatism introduces a bias to financial statements and thus, it contradicts neutrality and thence with the interpretation of the principle of decision useful information.

Numerous theories and models highlight the benefits of conservatism, whereas others emphasise the need for neutrality. Trying to find harmonisation between conservatism and neutrality seems to be impossible as they contradict each other internally. Conservatism leads to a bias in financial statements. It is debatable whether it is a negative bias. As neutrality prohibits any bias, conservatism has no justification in neutral financial statements. Nevertheless, conservatism can be found in the standards.

Respondents of the IASB argue that, *"[…] neutrality is impossible to achieve […] relevant information must have purpose, and information with a purpose is not neutral. In other words, because financial reporting is a tool to influence decision-making, it cannot be neutral."*[185]

To draw a conclusion, whether neutrality or conservatism should be in the Conceptual Framework's principles is be impossible. To argue, whether neutrality or conservatism encourages more information content is seriously challenging. According to previous examination, the answer always depends on situations with given assumptions or estimations that particularly lead to different outcomes. Thus, it cannot generally be said

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[183] Cf. also Wagenhofer/Ewert (2011b), p. 125.
[184] Cf. e.g. Watts (2003a); LaFond/Watts (2008); Armstrong et al. (2014).
[185] IASB (2015a), p. 116–117.

that neutrality contributes to more decision useful information, whereas conservatism does not always imply the provision of no information content. Considering only information content in financial reports, conservatism might play no significant role in the case of efficient information allocation. Efficient information allocation would have the effect of allowing the user to be able to determine all distortions and take them into consideration when making a decision. However, there might be no efficient information allocation but rather information asymmetry caused by uncertainty about future events, actions etc.

Empirical research shows that conservative reporting occurs more often but also highlights possible negative impacts regarding severe earnings distortions through the implementation of conservatism. Conservatism can also hinder earnings distortions (i.e. earnings management) caused by managerial compensation-incentives. Managerial efforts to transfer the firm’s wealth to themselves should be hindered by conservatism.

A challenging concern appears to be that the IASB only focusses on the investors’ interest. It is suggested that there may never be a uniform pool of interest as there are always different judgements and estimations, time horizons or risk aversions. Investors may have individual interests and thus, faithful presentation of a company’s performance could be seen as a valuable contribution. A neutral view of the business should provide a useful judgement possibility of the firm’s value. However, accounting is used for so much more e.g. contracting, managerial effects in information asymmetries, litigation, tax effects…[186] The IASB, nevertheless, pays little attention to these fairly important perspectives. Investors and other stakeholders may also be interested in dividend pay-out policies, the business capitalisation and future possible losses. Additionally, management’s actions operating the business may be a big investor’s concern and lead to considerations of compensation contracts, and investment efficiency.

There are sufficient cases supporting conservative accounting for stakeholders and especially for investors. The occurrence of conservatism in empirical studies may show the overruling existence of conservatism in accounting. Conservatism does not merely bring distortion and bias of information with it, but may also contribute to benefits. It should be possible for an

[186] Cf. Watts (2003a).

investor to unravel accounting distortion imposed by conservatism, by doing an accounting analysis, for example. However, it is impossible to claim for already paid out dividends if a recognised profit does not take place. Respectively, when a recognised uncertain loss vanishes, the money that has been put aside' can then flow to the residual receiver. That might imply that investors are more interested in possible losses than possible profits because not recognising an uncertain loss could probably do more harm to the company than not recognising an uncertain profit. Respectively, a possible future profit could also provide useful information and could persuade an investor to provide capital. Studies also show that humans naturally tend to weigh losses more than profits.

Regarding the loss recognition and investment efficiency, the business' performance is determined through different perspectives:

- *"Decreasing the adverse effects of information asymmetries and facilitating the monitoring of investment decisions.*
- *Increasing managerial incentives to abandon poorly performing projects earlier and undertake fewer negative net present-value investments.*
- *Facilitating access to external financing at lower cost."*[187]

The existence of moral hazard and the lack of available funding as a consequence of the high cost of external financing result in a deviation from the optimal investment policy. Especially in times of crisis or recession, a conservative accounting choice might serve to prevent future collapses as a result of overstated assets or too optimistic managements. Controversially, it might be possible that conservatism causes a negative downward cycle in recessional times and businesses would enjoy better conditions when staying with the principle of neutrality and fair values.

Uncertainty and existing information asymmetries probably play the most significant role in financial reporting. As a company needs capital to operate, it is essential to signal being a positive type to the lender, which means the ability to pay back borrowed money. Contracts

[187] Cf. García et al. (2011).

therefore will be indispensable and conservatism could be one means of gaining creditor's trust and keeping interest payments low. A creditor might be price protected by asking for the rational expected value for the rate of return which, however, does not distinguish between the good type and the bad type debtor and does not provide the optimal solution.

Despite the emphasis in the literature of considering conservatism as an impact on financial reports, standard setters pay little attention to academic research arguments and it is also noted that standard setters' concerns might not be directly linked to the extensive literature. It is indeed discussed how conservatism could be a positive issue for accounting standards. But arguments cannot be found to demand or encourage the introduction of conservatism in their practises.[188] An effective enhancement to the standard setters` future concern would be that they disengage from their traditional bias and do not totally ignore conservatism.[189] Conservatism is a current issue in accounting systems and can also provide economic value to users of information.[190]

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[188] Cf. Wagenhofer/Göx (2009), p. 2.
[189] Cf. Barth et al. (2008).
[190] Cf. Göx/Wagenhofer (2009), p.2.

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