



The Effect of Accounting Conservatism and its Impacts on the fair Value of the Corporation

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Abstract

This study mainly aims to elaborate the impact of the conservatism accounting on the fair value accounting. Therefore, we are motivated to shed light on the concept of accounting conservatism and fair value in financial accounting. Second goal is to illustrate the main characteristics of accounting conservatism and fair value. Third goal is to explain the impact of the accounting conservatism on the fair value.

This study attempts to investigate whether the accounting conservatism is related to firms' fair value and their financial decisions. We intend to use the descriptive approach in order to achieve the objectives of the study, to review the relevant literature on conservatism accounting and fair value, and to test the validity of the formulated hypotheses. The descriptive approach is reliable in this type of research, and the design of the questionnaire will be included in the study as the main adaptable component dependent to this methodology. Certainly, we have a set of variables: the reliability of accounting conservatism, the relevance of accounting information, and the benefits to fair value.



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Keywords: conservatism accounting, fair value, financial accounting, firms.

INTRODUCTION

Many researchers suggested to adopt a number of accounting conservatism measures to realize its effect on many interesting areas in the corporation (Bandyopadhyay et al, 2010). Typically, the current methods used to determine estimates and ensures of reasonable assurance on fair value and performance of business were investigated in many researches. Thus, the financial audit requirements and management capabilities have been conducted relevant to the position, value, and performance estimates of the business (Mrša et al, 2012).

Financial statement is found to provide the useful information to the users to help them in making economic decisions. For example, financial statement provides information of financial position, changes in financial position, and the performance of the enterprise. The employees, investors, suppliers, lenders, customers, and the governmental organizations and agencies are the major users of the financial statements (Bertoni and Rosa, 2005). Accounting conservatism refers to the outcome of uncertainty in earnings presentation of the firms that measured by the difference between returns on investment and earnings or the Earnings Response Coefficient (ERC). Particularly, accounting conservatism also is called the information asymmetry in accounting; higher implication in ERC information asymmetry leads to higher level of conservatism (Mrša et al, 2012).

The concept of fair value refers to the amount of assets, stable liability, and responsible parts in the financial transactions. Fair value could be the market value of an item if the



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market is efficient considered, independent parties, and no information asymmetries (Bertoni and Rosa, 2005). Computing fair value requires calculating the current asset value by recognizing the income or loss of the asset over period to reflect the value of the company. The accounting conservatism is different than fair value with respect to the speed of recognizing the financial statement profits; fair value produces asymmetry timing realization of unrecognized profits. The caution principle should be neglected in calculating fair value, whereas the accounting conservatism should not be low in firms to avoid dangerous dimensions to the investors and firms. Hence, the accounting conservatism is safely value beside the urgent and unexpected replications of the revenues and asset values. In contrast, relying on fair value extremely might increase the potentiality of carrying prices risks suddenly (Al-Awawdeh, 2015). The increasing fair value yields more generated revenues of the assets, as well as the income will increase in the assess management. Sometimes, the changes in fair value of liabilities and assets have not an impact on earning; some standards need to involve the encountered changes equally once they are realized and show them in the income statement (Bertoni and Rosa, 2005).

Different factors reflect the market prices, i.e. transaction costs, present value of future prices, insufficient market liquidity, and solvency risk (Bertoni and Rosa, 2005). The factors of the strong impact of the accounting conservative are: ownership, low market liquidity, pre-mature revenue recognition, underestimation of bad debt, and transfers of risks (Mrša et al, 2012). Several methods can be used to determine the fair value if the market value cannot be attuned to find item's fair value or if they are unavailable. Some of these methods are (Bertoni and Rosa, 2005):

- Disconnected cash flows: the measurements that are employed by appropriate discount rate to measure the liabilities and financial assets.



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- Carrying amount: the measurement of short period financial assets such as accounts receivable or payable that live in short period of time from the origination to the realization, as well as the loans that their prices change repeatedly at market over time and do not require a new measuring and calculating in the fair value.
- Valuation models: the measurements measure the derivative financial assets in excessively active markets such as stock market that hold an option to grant the employees to use derivatives in hedging.

Based on the disclosures of the fair value measurements stated under the Statement of Financial Accounting Standards (SFAS), the authors of the study identified the extent of the choice of firms in terms of fair value measurements. In general, the narrow meeting of earning targets conflicted with the conditional conservatism yields less conditionally conservative fair value measurements (Badia et al, 2016).

OBJECTIVES

This study mainly aims to elaborate the impact of the conservatism accounting on the fair value accounting. Therefore, we are motivated to achieve this goal by accomplishing the following sub-objectives:

- To shed light on the concept of accounting conservatism and fair value in financial accounting.
- To illustrate the main characteristics of accounting conservatism and fair value.
- To explain the impact of the accounting conservatism on the fair value.

QUESTIONS



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This research attempts to investigate whether the accounting conservatism is related to firms' fair value and their financial decisions. Based on the outlined objectives we carry out, the main questions we carry to answer are:

- Are the effects and consequences associated with accounting conservatism certainly recognized?
- Does the accounting conservatism affect the fair value?
- What are the effects of control variables on accounting conservatism and fair value?
- What is the type of the relationship between accounting conservatism and fair value?

HYPOTHESES

The researcher in this study seeks to test and validate the following hypothesis:

- There is no impact of statistical significance of the accounting conservatism on the fair value.
- There is no significant impact of the control variables of decision supporting and financial reporting on accounting conservatism and fair value.

Moreover, these hypotheses are also divided into two hypotheses:

- Accounting conservatism contributes to provide the benefits to fair value.
- There is no relationship between the accounting conservatism and fair value.

LITERATURE REVIEW



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Most of researches on the accounting conservatism measured the assumption of accounting conservatism theoretically by detecting the methods that rely on accounting reaction to bad news about the capital market and business risk assessment to adjust financial reporting positions. Other literatures described the accounting conservatism as an internal generated predictive measure of future cash flows. However, the researchers interested in the accounting conservatism should pay a special attention to the direct impact of accounting conservatism particularly with respect to the risk mitigation and management. Referring to the research on management forecasts and accounting conservatism, many researches have argued that the accounting conservatism should provide the prediction power to the firms to predict future performance, as well as should provide a significant tool for accounting management.

In (Lee, 2011), the author has examined the association between conservatism and the financial flexibility and financial decisions. In other words, the study explored the pay-out policies, liquidity management, investment cash flow sensitivity, and choice of debt or equity financing. The main findings of the study demonstrated that firms with larger conservatism showed lower flexible financial decisions. Therefore, the accounting conservatism declines the presence and the strength of firms' balance sheet that let managers to behave more conservatively and financially constrained in more financial decisions. The paper has been developed due to the lack of the evidence on the effect of conservatism on corporate decisions in the literature. The suggestions presented by the paper confirmed that if debt contracting is more costly, the firms report more conservatively behave. Moreover, the firms exhibit less flexible finance particularly in financial decisions. In conclusion, the study provided a defence to the reasons that let standard setters desire free of bias and neutral accounting information, and the causes of avoiding the concept of conservatism in the conceptual framework.



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The authors of (Elkotayni et al, 2014) intended to show the relation between the financial failures and the accounting conservatism in 60 industrial corporations listed on the Amman Stock Exchange (ASE) in order to build a prediction of the failure in early and advanced stages. The focus was on the measuring the level of the conservatism documented by the investigated corporations. The authors used two models: Basu, 1997 and Altman and MCCough, 1995 to forecast the financial failures to achieve their intended objectives. They used multiple linear regression model in testing the study hypotheses. The study was conducted in the period from 2008 to 2012. The results of the study have confirmed previous studies that their results are consistent with the result saying that there is an accepted degree of accounting conservatism in the conducted corporations and there is a weak influence of the accounting conservatism on the prediction of financial failures in these corporations. The accuracy of the proposed prediction model was 88%. The authors recommended the governmental organizations in Amman Financial Market compel corporations to follow the universal average of the accounting conservatism to reduce the risks of the financial failures. Moreover, they argued to monitor operating in Jordan to increase audit procedures and verifications that yield more transparency, fairness, activated control, customers commitment, and accurate financial reports. Finally, the accounting conservatism is one of the indicators of failures and leads the corporation to financial failures.

The study of (Elfaki and Hammad, 2015), addressed the effect of the application fair value accounting on the characteristics of accounting information. Three approaches: descriptive, inductive, and deductive have been followed to achieve the objectives of the study. From literature, many studies have reviewed the impact of fair value accounting and analysed its components using the inductive approach, whereas the researcher adopted the deductive approach to formulate the hypotheses of the study. Therefore, the researcher used the descriptive and statistical approach to analyse questionnaire data in



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social studies. The study recognized a positive relationship of the fair value accounting; it produces useful information for financial statements creation, reliability of accounting information and decision-making.

The study of (Al-Awawdeh, 2015) aimed to check the impact of the accounting conservatism on the fair value in Jordan. The study has accompanied a survey on a sample of 30 Jordanian industrial companies over six years from 2006 to 2013. The study selected fair value as a dependent variable, whereas the accounting conservatism was selected as an independent variable. In addition, there were five control variables, specifically the proportion of fixed assets, the size of the company, the ratio of ownership, the rate of assets realization, and distributed dividends. The results of the study showed that there is a difference between the degree of incorporating accounting conservatism in the operations of the conducted industrial Jordanian companies and the state of accounting conservatism. Therefore, the authors noticed the presence of a variation in the conducted companies size, the responsibility percentage, and the distributed profits rates. In general, the fixed assets ratio of the conducted companies is closer. In conclusion, the study demonstrated the reverse relation between the accounting conservatism and the fair value. Moreover, the critical role of the low accounting conservatism in fair value was clarified, therefore. the relationship between the accounting conservatism and fair value is negative. The results also revealed that control variables have an impact on fair value, i.e. the company profitability and assets showed a positive relationship, and the ratio of debts showed a negative impact on fair value.

In the paper of (Mrša et al, 2012), a survey of the related accounting approaches that deal with information asymmetry, harmonization, and uncertainties implications was piloted for fewer developments of the capital markets. More conservative and aggressive accounting policy approaches lead to more quality of accounting information. The paper added a special interest in the latest updates on International Financial Reporting



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Standards (IFRS) conjunction, mainly for United States Generally Accepted Accounting Principles (US GAAPs) and consistent with the Financial Accounting Standards (FAS) Boards statement that reported comprehensive income and fair value measurement. The paper recommended to follow the accounting standard setters principles regarding the uncertainty and accounting conservatism for better quality in financial reporting quality measurement. Additionally, the firm's management is not able to follow these standards and principles.

In (Manganaris et al, 2011), the authors examined the status of the conservatism and fair value existing in four European countries namely British, Greece, France, and Germany. The study has covered the existing conservatism over the period of 1999-2008, and the level of the change over the same period in order to determine the impact of conservatism on the earnings value. The approach implemented by the study was regression model using Basu's and Easton and Harris's model to measure the conservatism and fair value. The results were derived for each country and for each level of conservatism. The main evidence was inferred is that the conservatism was located in four countries. However, the conservatism in Germany and France was decreased after the IFRS adoption after 2005. Therefore, the perception of the fair value in all countries reduced except in UK. In conclusion, several institutional factors in European countries have continued to exist even after IFRS implementation, whereas the used models by the approach were not effectively working in the next time.

In the paper of (Badia et al, 2016), an examination of the incorporating financial instruments was presented. The common belief in unbiased fair value measurements was disinterested. The paper added evidence that the higher proportion of financial instruments reported higher conservative comprehensive income attributable to fair value measurements. The study was conducted on the fair value measurements and reserves of the oil and gas companies in order to gain reliable results. When the instruments have not



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price in the market, the market discipline will be limited over the measurements. The measurement of fair values was done based on level 2 or 3 inputs. The findings of the study are in the same line of the other studies; the fair values with measures level 2 and 3 are predictably to avoid discounting the measurements by the investors. Thus, the study concluded that the conditional conservatism can increase under control and governance mechanism, as well as the strength of the firm will increase with respect to the conservative reporting. While the earning management incentives will be decreased under these conditions. In contrary, there was no relationship between the level proportion of fair value measurement and conditional conservatism.

The authors of the paper (Bertoni and Rosa, 2005) aimed to establish a conceptual outline of the decisions made by the International Accounting Standards Board that set rules of financial performance measurement. The paper was established and dominated based on the emphasis of accounting conservatism in literature and tradition in Europe. The paper examined the problems and challenges rising by the advent of assorted model of accounting conservatism outlined in a strongly developed framework with respect of cultural and legal factors. The authors of the paper have argued that there was inconsistency in some aspects of the IASB standards, therefore, they believe in the neediness to improve the model by involving a comprehensive income in that model.

An investigation of the effect of accounting conservatism on financial indicators of the performance of 12 Jordanian insurance companies listed in Jordan Securities Exchange Commission (SEC) was introduced in (Sana'a, 2016). The independent variable was the accounting conservatism, while the control variable was the size of the company. The study was conducted over the period of 2007 to 2014 based on the market value of the share, return on assets, and Earnings Per Share (EPS). The aim of the study was to examine the effect of the independent variable namely accounting conservatism and the control variable namely the size of the corporation on the financial performance of the



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corporation. The study was conducted in the Jordanian insurance corporations. The authors used the annual reports of the companies to collect the necessary data to determine the practice of the accounting conservatism policies in that companies. The results of the study have confirmed that the Jordanian insurance companies practiced the accounting conservatism policies, thereby the impact of the practice of the accounting conservatism is positive and significant to the financial performance of that companies. The authors concluded that the regulators and official supervisors of the accounting in Jordan adopt the proper policies that motivate the companies to accept the level of the accounting conservatism with increased their oversight of the Securities Exchange Commission.

METHODOLOGY

The accounting policy options should take accounting conservatism as a dependent variable for explaining the reaction of the firms to uncertainty and future cash flows prediction (Mrša et al, 2012). We attempt to specify the trade-off in the cost benefits of the accounting conservatism with respect to the financial reports and reporting firms' users. Therefore, we attempt to model the accounting related determinations of the liability and asset liquidity. In other words, we want to identify whether the accounting conservatism and fair value measurements can interrelate or overlap.

We intend to use the descriptive approach in order to achieve the objectives of the study, to review the relevant literature on conservatism accounting and fair value, and to test the validity of the formulated hypotheses. The descriptive approach is reliable in this type of research, and the design of the questionnaire will be included in the study as the main adaptable component dependent to this methodology. Certainly, we have a set of variables: the reliability of accounting conservatism, the relevance of accounting information, and the benefits to fair value.



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In our analytical method, we will provide a description of our vision and insight in order to follow the right steps to achieve our goals. In this section, we should identify the sample of the study, population, data collection tool, and statistical methods that we will use for data analysis. We will select a sample of the 100 companies from the period of 2016-2018 to review the financial reports published by these companies. We will use different statistical tests and methods to validate our hypotheses; T-test, White-test, linear regression, F-statistics value, etc. will be used in our analysis. The independent variables and control variables will be tested to link them to the accounting conservatism and fair value. This study involves a sample of a number of companies working in investment firms and banks sector to conduct the survey and collect desired data.

For evaluation method, we use the regression equations to assess our results based on our experiment. Certainly, the use of regression analysis has proved a significant contribution to evaluating the impact of different variables on the accounting conservatism. The author of this study intends to apply multiple linear regression to test the hypotheses. The study uses the multiple regression analysis to test the hypotheses of the study and to determine the practice of accounting policies. In addition to multiple linear regression, we will use the least squares approach in the form of regression equations to link the independent variable accounting conservatism and control the dependent variables.

Discussion and Results

The importance of conservatism appears in the lower cost of debt benefits to borrowers, therapy providing lenders interventions and covenant violations that yield more power (Lee, 2011). The significance of this study comes from the importance of fair value accounting in financial institutions and the role of conservatism accounting in supporting fair value to strengthen the positions of the enterprise.



The importance of this study refers to the following facts:

- The importance studying and analysing the accounting conservatism and their principles and standards to help people interested in, and to identify the effects of the accounting conservatism on the fair value of the corporation based on the financial reports and earnings.
- The significance of submitting useful information to the main users of financial reports regarding accounting conservatism as a base in decision-making, as well as the need of having reliable, objective, and credible financial reports.
- The lack of providing useful knowledge about the effect of the accounting conservatism on the performance of the corporation as one of the important indicators of the improved performance and enhanced competitive advantage for the corporation.
- The need of measuring the role of the accounting conservatism in detecting the efficiency of the insurance companies.
- The provision of an added vision to the accounting conservatism investors about the developments, regulations, and benefits of incorporating high levels of the accounting conservatism especially in terms of the fair value.

New accounting standards have been adopted by the accounting standard setters over the past time to enhance the practicality of financial information reporting. In particular, most of the developed standards include the early realization of the losses and expenses, requiring the involvement of current earnings for future estimates (Bandyopadhyay et al, 2010). We are motivated from the result of the increasing interest in the accounting conservatism and therefore the increasing association between the accounting conservatism and the fair value of the corporation. We intend to improve the literature



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relevance to accounting conservatism and its future reflections on the fair value of the firms.

Certainly, this study is not concerned with distinguishing between the effects of the conditional against unconditional accounting conservatism. This research will conduct both firm-level and industry level analysis through the assessment of the correlations between financial reporting information, the indicators of the performance of the firm, the accounting conservatism and the fair value.

The effect of the accounting conservatism has received extensive attention form literature, professional, international and regional perspectives. Many researches have revealed that the accounting conservatism can improve the performance of the corporation and limit the behaviours of the managers. In contrast, other researches have reached that the accounting conservatism results negatives to the corporation and therefore decreases their performance.

The impact of accounting conservatism has been explored on many other components of the accounting system. The problem of determining the type of the impact of the accounting conservatism on the fair value should be investigated, especially manufacturing organizations. In this research, we contribute to the discussion the benefits and costs of the accounting conservatism through viewing the role of the increasing or decreasing accounting conservatism in enhancing the fair value of the corporation.

Conclusion

In this research, we contributed to the discussion the benefits and costs of the accounting conservatism through viewing the role of the increasing or decreasing accounting conservatism in enhancing the fair value of the corporation. The descriptive approach is reliable in this type of research, and the design of the questionnaire was included in the



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