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Review Paper

THE CONSERVATISM PRINCIPLE IN MODERN FINANCIAL REPORTING

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Abstract. *Various studies point out that the principle of conservatism (prudence) has been too long in the field of accounting, which makes it almost irreplaceable. However, the development of accounting is in line with constant expansion of the circle of stakeholders who impose new requirements regarding information on sources of income, destination of expenditures and calculation of periodic results. This inevitably leads to changes in financial reporting, aimed primarily at applying the fair value concept.*

Key words: *the conservatism principle, the historical cost concept, the fair value concept*

JEL Classification: M41

INTRODUCTION

Modern financial reporting requires high-quality accounting standards, able to respond to a number of challenges that business entities face. Financial statements prepared in accordance with the relevant principles and the standards built on them meet the information requirements of numerous stakeholders. The modern accounting tendency denies the importance of certain traditional accounting principles, the conservatism principle (prudence) in particular, with the aim of promoting the fair value concept.

The fair value concept provides detailed information on conditions under which business entities operate, the market value of their assets and liabilities and provides a better basis than the historical cost concept, to gain from efficient business risk perception. In other words, the fair value concept is oriented towards the future, while the historical cost concept (with its conservatism principle) is oriented towards the past. This paper shows the importance of applying prudence in the process of generating high-

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quality accounting information in order to point out the consequences of inadequate application or even abandoning the conservatism principle. Also, our goal is to point out the potentials of simultaneous application of the conservatism principle, as an integral part of the historical cost concept, and the fair value concept.

1. Contribution of the Conservativism Principle to the Higher Quality of Accounting Information

One of the oldest accounting principles is the conservatism principle (prudence). Despite its traditional dominance over other accounting principles, highlighting its importance in financial reporting, theory lacks its uniform definition. The most common is Bliss's definition of 1924, which is used today as an accounting saying, indicating that in conservatism no gain (income) should be anticipated, but that every loss (expense) should be predicted (Thijssen & Iatridis, 2016, 49). Basu also gives a well-known definition of conservatism in his 1997 paper, in which he defines conservatism as an asymmetry in the recognition and presentation of profits that provides a faster and more complete response to "bad news" than "good news" in doing business (Hansen, Hong & Park, 2018, 76).

The results of numerous studies on the desirability of applying accounting conservatism in modern financial reporting show that a number of theorists and practitioners mark this principle as a basic characteristic of financial reporting, which is contrary to the opinion of standard setters. On the one hand, theorists and practitioners believe that conservatism tends to emphasize reliability in relation to the relevance of information provided (Balachandran & Mohanram, 2011), while, on the other, removing reliability from the group of desirable information characteristics means nothing but that standard setters believe that only information that does not contain elements of conservative bias can be called quality information. Omitting reliability expressed as a requirement to apply a certain degree of prudence when preparing financial statements from the *Conceptual Framework for Financial Reporting* also means pushing the principle of conservatism (prudence) into the background (Savić, 2014, 28). In other words, standard setters believe that the conservatism principle is contrary to the requirement that financial statements should present neutral information to decision makers.

The financial market looks at the quality of accounting information in terms of its credibility, seen as the impact of the presented results on the entity's market value. The value or relevance of accounting information (primarily, financial result) represents "the degree to which book values agree with market values" (Thijssen & Iatridis, 2016, 59). Most studies find a positive link between the level of conservatism and the value that accounting information has for decision makers (Kousenidis, Ladas & Negakis, 2009). In other words, viewed from the perspective of a number of stakeholders, the value of accounting result derives from its ability to explain market returns (Francis & Schipper, 1999). Accounting conservatism increases the timeliness of bad news, i.e. it warns managers and, more importantly, investors in time, who insist on the application of conservative rules in conditions of uncertainty. The studies show that entities that face greater uncertainty report more conservatively (Hsieh, Ma & Novoselov, 2019, 41). However, there are studies indicating that the higher the conservatism, the lower the information relevance, i.e. that there is a negative relationship between these values (Basu, 1997). This is especially true for intangible assets, which are very difficult to value, so conservatism may decrease the value of information provided by the accounting system (Thijssen & Iatridis, 2016, 50). "In certain cases, such as the permanent market crisis, higher levels of conservatism appear as a natural mechanism for investor protection" (Kousenidis, Ladas & Negakis, 2009, 221). The results of the research indicate a gradual increase in the level of conservatism in the USA and several EU countries after the market crisis in 1999 (Grambovas, Giner & Christodoulou, 2006). The outcome of the Asian financial crisis shows that "conservatism decreases during the crisis" (Gul, Srinidhi & Shieh, 2002), but grows after a period of financial crisis (Vichitsarawong, Eng, & Meek, 2010). A study conducted in 2011 (immediately after the last economic crisis) of over 100,000 entities from the United States finds that the level of conservatism increases (Balachandran & Mohanram, 2011). It is believed that the increase in the level of conservatism is due, above all, to the increase in the timeliness of recognizing losses.

Conservative reporting "can increase the reliability of financial information because conservatism results in fewer estimates (and, thus, more objective measurement)" (Balachandran & Mohanram, 2011), reflecting a close correlation with market values (Kousenidis, Ladas & Negakis, 2009). Also, insufficient reliability of information narrows the choice of potential solutions and limits the effects of decisions made by investors, so conservatism is considered to be aimed at increasing rather than decreasing the value of information on business results (Kousenidis, Ladas & Negakis, 2009, 220).

2. Potentials of Abuse of the Conservativism Principle

The benefits of conservative reporting are not unlimited. An extremely high level of conservatism will reduce rather than increase the relevance of accounting information for decision-making purposes (Kousenidis, Ladas & Negakis, 2009, 221). The research results provide empirical support for the Watts's theoretical basis of 2003, who, on the one hand, reports "numerous arguments in favor of conservatism, but, on the other hand, raises questions about the practice of expensive conservative reporting", which is a potential reason for distortions of the correlation between result and market return (Kousenidis, Ladas & Negakis, 2009, 219). Empirical studies indicate that the conservatism principle in the conditions of IAS/IFRS is applied more on a temporary rather than a consistent basis. In the conditions of IAS/IFRS, "the principle of conservatism is not applied consistently, but on an *ad hoc* basis, i.e. according to the current entity and/or management needs" (Savić, 2014, 34). The temporary application of conservatism in accordance with the specific circumstances and entities' goals is reflected in the accounting treatment of certain events (overestimation of provisions or underestimation of income), which leads to the creation of hidden reserves, which will result in uniform or increased results. Users of financial statements see this situation as a source of potential information asymmetry, due to much more complex effects on the determined result in relation to the consistent application of this principle (Helman, 2008, 82), which will have significant repercussions on the quality of presented information.

The historical cost concept and its so-called *ex ante* assessment of the value of assets and liabilities in uncertain business conditions, i.e. asset write-off and considering contingent liabilities are the main sources of hidden reserves as a certain degree of protection against numerous business risks (Savić, 2014, 33). As a segment of equity that is not shown in the balance sheet, hidden reserves are usually created by underestimating assets, but also by overestimating liabilities. The primary objective of hidden reserve formation is to prevent serious fluctuations in the results presented in the financial statements from being disclosed. Specifically, sudden changes in the amount and structure of the financial result can create a public image of unstable business, which consequently affects the risk of investing in entity's shares. The frequency and proper timing of the formation and decomposition of hidden reserves is a means aimed at achieving time uniformity of results, which is the main argument of critics of hidden reserve policy and its source – the accounting conservatism principle. "It is necessary to develop a culture of creating and decomposing hidden reserves, whose intention is not to mislead balance sheet recipients and lead to wrong business decisions, but to contribute to protecting the interests of the corporation in a dynamic and change-prone business environment" (Savić, 2014, 34). Opponents of the policy of hidden reserves point to its contraindications, manifested by endangering the principle of truthfulness, since "hidden reserves are created not by underestimating the net assets in any balance sheet, but only the one that is true and accurate" (Ranković, 2008, 423).

In addition to influencing the presentation of entity's current business situation, the conservatism principle indirectly has an impact on the accuracy of predicting future results. Specifically, managers who have superior business information in relation to all other stakeholders should be able to predict the future expressive results and the impact of accounting conservatism on them. In other words, managers need to be able to adjust their forecasts of the next accounting period (or even more subsequent periods) to the effects of conservatism (Sun & Xu, 2012, 64). However, in addition to objective limitations (such as the necessary accounting knowledge and experience gained in many years of accounting practice), managers also encounter a subjective limitation in making their predictions embodied in the form of opportunism. Specifically, this managerial personality trait can influence their decision to adjust predictions of the expressive result with reference to a certain degree of conservatism. Literature (Sun & Xu, 2012, 66-67) points to three sources of managerial opportunism, which figure as the most important reasons for incomplete forecasting of future results and their inadequate adjustment with reference to the effects of historical (existing) degree of conservatism: 1) planned external business financing or investment in the forthcoming period, 2) "field preparation" for the implementation of planned mergers and acquisitions, and 3) direct conflict of interest and situations when managers plan to cash in on the shares of the entity they manage. When it comes to the first source of managerial opportunism, Lang and Lundholm (Lang & Lundholm, 2000) suggest that managers are optimistic in predicting results when applying for additional external capital. The artificial increase in results is done in order to deceive creditors regarding the business prospects and entity's potentials in order to reduce the price of borrowed capital. Given that accounting conservatism leads to an underestimation of the stated result, managers try to reduce the degree of conservatism in their predictions when they anticipate the need for external capital. Another source of managerial opportunism appears in a study by Erickson and Wang (1999), who find that entities have an incentive to increase their results before initiating mergers and acquisitions in order to reduce the cost of business growth. Also, Kravet (2014) finds that under more conservative accounting practices, managers make less risky acquisitions. That is why managers consciously underestimate the influence of conservatism on results and publish optimistic predictions of results as much as possible. In explaining the third source of managerial opportunism, the study by Rogers & Stocken (2005) will help, which indicates that managers tend to disclose optimistic forecasts of results when planning to sell their shares in the entities they manage, i.e. the findings show that managers will not adjust results based on the cumulative historical effects of conservatism, and that pessimistic performance predictions are reserved for the accounting period in which managers plan to purchase entity shares. Viewed from the perspective of shareholders, conservatism in financial reporting reduces managerial motivation and willingness to invest in riskier investment projects with a positive net present value, which leads to the occurrence of lost returns and represents an opportunity cost or the price of conservatism.

The phenomenon of accelerated globalization and internationalization of capital markets has opened up topics of transparency and timeliness of financial reporting (Neag & Masca, 2015, 1114). Entities face increasing business uncertainty, and, in order to survive on the market, their managers need to adhere to prudence in decision-making (Ben-Haim, 2014). In other words, the benefits of applying the conservatism principles in modern financial reporting "by far outweigh its weaknesses" (Škarić-Jovanović, 2015a, 63). Emphasizing the requirements for detailed *ex post* reporting on business results and their impact on stock prices, accounting conservatism points to the importance of *ex ante* information on low returns on investment projects (Ball, 2001), i.e. before their implementation, as well as in their early phases, whereby "conservatism increases the value of work-based learning" (Hsu, Novoselov & Wang, 2017). As a striving for stricter verification of "good news" and recognition of their consequences (gains) in relation to "bad news", accounting conservatism is "a measure that limits the riskiness of information from financial statements" (Lin, Wu, Fang & Wun, 2014, 164). In this way, accounting conservatism helps investors and a number of interest groups by controlling managers' activities (Hsieh, Ma & Novoselov, 2019, 44).

3. The Possibility of Coexistence of the Conservativism Principle and the Fair Value Concept

The conservatism principle, which leads to the recognition of realized transactions and events with material effects on the financial statements, does not provide information that is a good indicator of business risk, which is why it is not suitable for fully meeting the information requirements of investors. Emphasis on the importance of information requirements of investors and creditors and their definition as primary users of financial statements is there because these users invest their financial resources in the entities' operations and are the main participants on financial markets. Accounting information that meets the information needs of primary users is considered to fully meet the information needs of other users of financial statements. It is precisely fair value that has been developed in response to the needs of capital market participants who use anticipated financial data in order to appropriate anticipated profits (Richard, 2015, 24).

3.1. The fair value concept in modern financial reporting

The fair value concept emphasizes the relevance of financial information, while the historical cost concept emphasizes reliability as one of the most important qualitative characteristics of financial information. "Current economic values presented in the balance sheet, rather than assets and liabilities recognized at historical cost, represent real investor requirements" (Benston, Bromwich, Litan & Wagenhofer, 2006, 261). In this way, the purpose of preparation of accounting information changes, i.e. what changes is the direction of the reporting procedure towards the credible presentation of relevant financial information that will be used for timely business decisions. The accounting basis for this approach is the fair value concept, which ensures the achievement of this objective when applied to the entity's assets and liabilities from period to period.

The fair value concept was developed in the Anglo-Saxon states. The development of their financial-accounting theory and practice is based on the view that fair value is an objective value and represents the optimal basis for financial reporting. "Since the accounting system is determined by the characteristics of the financial system, and the Anglo-Saxon financial system is based on the capital market, the acceptance and application of the fair value concept in Anglo-Saxon practice has a consistent logic and full justification" (Knežević & Pavlović, 2008, 8). It is the transition "from the historical cost concept to the fair value concept" that is "driven by market observation of relevance" (Hitz, 2007).

Financial statements prepared in accordance with the fair value concept should reflect economic reality and market conditions, i.e. should provide information on assets and liabilities valued at current market prices. Investors need this information to determine whether their share in the fair value of net assets is optimal or needs to be changed (increased or decreased), as well as to monitor management activities. The main objective of financial reporting according to the fair value concept is to determine the amount of fair value of net assets at the reporting date and view the financial result of operations "simply as changes in fair value of assets and liabilities shown in the balance sheet" (Škarić-Jovanović, 2009, 422) between the two reporting periods, i.e. changes in the fair value of net assets at the end of the reporting period in relation to its beginning. Therefore, the reported result includes market-verified gains and losses, but also gains and losses that are not realized on the market, which are a consequence of the increase or decrease in the fair value of assets and liabilities at the reporting date. The similarity between the two concepts is the recognition of losses at the time of their occurrence, and the difference relates to the treatment of gains, since the historical cost concept recognizes gains only after their realization, and according to the fair value concept at the time of their occurrence. The consequence of this measurement of results is the acceptance of the view that "the balance sheet has priority in the annual financial reporting", while "the income statement has a secondary role" (Stojilković, 2011, 94). This is in line with the fact that "often contracts with customers contain such clauses that it is difficult to determine the actual amount of revenue generated by the supplier, which relates to the reporting period" (Spasić & Arsenijević, 2017, 53).

The new IFRS and the revised IAS adopted at the beginning of the 21st century include the possibility of expressing the value of individual items in accordance with the fair value concept. However, at the beginning of the application of this concept, no standard defined the procedure for measuring fair value, which quickly proved to be necessary. In May 2011, the IAS Board adopted IFRS 13 "Fair Value Measurement" with effect from 2013. IFRS 13 "provides guidance in determining the fair value of assets and liabilities of business entities and defines the rules for disclosing related information." The weak side of the application of the fair value concept refers to the potential impossibility of using inputs from the first hierarchical level defined in accordance with IFRS 13, which are the optimal indicator of the real value of a certain balance sheet item. As a result, there is a frequent application of inputs from the second and third hierarchical levels, which conditions the existence of (debatable) assumptions and assessment models.

3.2. Mixed basis of financial reporting

Although the concept of historical cost is a clear and practical method that consistently assesses the value of shares when they are not on an active market, theorists who support the fair value concept as a basis for financial reporting believe that the historical cost concept has lost relevance and should be replaced (Hitz, 2007). However, the reliability gap when it comes to the fair value concept contributes to the current situation in accounting theory and practice, which is that standard setters do not accept the fair value concept as the only accounting basis for financial reporting. In order to meet the information needs of modern users of financial statements (above all, investors), a mixed, i.e. combined basis of financial reporting is formed. The normative basis composed as a mixed combination of the two concepts "leads to the conclusion that none of the mentioned concepts alone can provide users with information relevant for making decisions on the allocation of available resources" (Škarić-Jovanović, 2015b, 327). The hybrid basis of financial reporting implies that the principle of neutrality and the prudence principle are applied together as conditions for credible presentation of information, where "prudence should be understood only as a reasonable response to uncertainties that properly takes into account environmental uncertainties and risks associated with the entity's operations" (Škarić-Jovanović, 2015a, 79).

Standard setters tend to make economic entities adjust their financial statements to the fair value concept, because financial reporting should be the basis for assessing and predicting future business performance. However, in order not to neglect the advantages of the older (historical) basis, the mixed basis for valuing certain forms of assets and liabilities prescribes mandatory compliance with the rules arising from the historical cost concept (for example, inventories and short-term receivables), for other forms of assets and liabilities based on the fair value concept (for example, financial instruments), and there is an alternative option for valuing third forms of assets and liabilities through the use of fair value or historical cost (for example, material investment). In that way, this normative basis is very complex for application, but also for understanding the financial statements obtained by its application (Škarić-Jovanović, 2015б, 331).

Also, it should be taken into account that IAS/IFRS are built on a mixed basis consisting of two concepts, the historical cost concept (related to the reliability characteristic) and the fair value concept (related to the relevance characteristic). In this way, financial statements present two types of information, reliable and relevant. Accounting standard makers and market regulators believe that the extended requirements imposed on entities when applying a mixed basis of financial reporting, which relate to fair value measurements, "increase the usefulness of financial statements" (Barth, 2014). Specifically, "when users of financial statements consider that the source of information is insufficiently reliable, they will not consider the information useful for making business decisions. In other words, fair value has less informative value when not reliably measured" (Hernandez Hernandez, 2004).

CONCLUSION

This research has shown that the fair value concept has a potential to provide more detailed information on the business conditions of economic entities, the market value of their assets and liabilities and a better basis than the historical cost concept to achieve benefits based on efficient business risk perception. The lack of the fair value concept is the absence of a standardized procedure and uniform fair value measurement procedures which have led to a decrease in the quality of financial reporting in the form of a drastic decline in comparability of data. The combination of elements of the historical cost concept and the fair value concept has been seen as the practical solution from many researchers' point of view.

As the research presented, the application of the conservatism principle is still very widespread in practice, which only proves that accountants and professional users of accounting information believe that financial statements will be more relevant and reliable if compiled in accordance with traditional accounting principles. Also, practice has shown that it is not realistic to expect that the application of a certain level of conservatism (as an essential element of the historical cost concept) can be standardized. The reason lies in the fact that the perception of prudence is closely related to the individual's personality (accountant, manager, investor) and their aversion to risk.

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PRINCIP KONZERVATIVIZMA U SAVREMENOM FINANSIJSKOM IZVEŠTAVANJU

Često se u literaturi može naći zapažanje da je princip konzervativizma (opreznosti) u službi računovodstvene nauke predugi niz godina i da ga ova karakteristika čini teško zamenljivim. Međutim, razvoj računovodstva praćen je konstantnim proširivanjem kruga interesenata koji nameću nove zahteve u vezi informacija o izvorima prihoda, odredištu rashoda i obračunu periodičnog rezultata. Ovo neminovno vodi promenama u finansijskom izveštavanju koje su usmerene, pre svega, na primenu koncepta fer vrednosti.

Ključne reči: *princip konzervativizma, koncept istorijskog troška, koncept fer vrednosti.*