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IMPACT OF ACCOUNTING CONSERVATISM PRINCIPLE ON CORPORATE PERFORMANCE

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Abstract

This paper aims to put light on the accounting conservatism and related investigation to explanation consequences on firm's value. Maximizing firms value would be one of the prominent concerns of board of directors in every place management process mainly 16 articles in the field of accounting conservatism form many journals have been reviewed concluded result explained distinctive result with this regard. Our suggestion is that to investigate more in this field of accounting to assure a concluded a uniform remark.

Keywords: *Accounting, Conservatism, Firm Value.*

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1. INTRODUCTION

Many scholars explain the role of conservatism principal on firm's performance and financial statements validity (Rashid, 2017; Noori & Rashid, 2017; Budur et al., 2018). This paper explains the current state effect of conservatism accounting principal on the efficiency of corporates (Budur, 2020; Rashid & Sabir Jaf, 2023). In effect, accounting conservatism can serve as an effective monitoring device by providing early warning signals of impending losses to shareholders, thereby mitigating the agency conflicts between managers and shareholders (Watts 2003; Rashid, 2023). With the monitoring device role, accounting conservatism is expected to be in high demand by shareholders when shareholder-management agency conflicts get more severe (Houston et al. 2016; Ni and Yin 2018; Budur et al., 2023; Jaf & Rashid, 2023).

In the study of Rashid (2020), which was a joint project reviewing and revising conceptual framework for financial reporting, prudence or conservatism has been removed from qualitative characteristics of financial reporting in favor of neutrality. This removal was due to a deliberate underestimation of net income and asset that can be understood as a bias against neutrality (Rashid, 2019). Some opponents of conservatism argued that conservative accounting could violate the matching principle, as it anticipates and recognizes future costs and losses while postponing the recognition of income due to uncertainty (Chen et al., 2014; Mahmood & Sabir, 2023).

In the past many argue from literature that board of directors would work in stakeholders' interest and applying conservatism principle, thereby help minimize deadweight losses thereby increasing firm values (Watts 2003, Caskey and Laux 2017; Rashid, 2018; Fatah & Jaf, 2023), this justify there is no reason to except a prior that directors will automatically maximize shareholders value (Bebchuk and Fried 2003; Rashid & Noori, 2017; Khadr et al., 2023).

In this paper we attempt to explain the perception by reviewing literature whether conservatism fulfill stakeholders demand and maximize shareholders value.

2. LITERATURE REVIEW

Haque, A., Mughal, A., & Zahid, Z. (2016), explained the Earning Management and The Role of Accounting Conservatism at Firm Level, by using a sample of 317 non-financial Pakistani firms consisting of 4204 firm-years over the period 1999-2013. Conservatism at the firm level is estimated by using the C-Score measure and earning management is observed by calculating discretionary accruals.

The estimated outcomes explain that one fourth (86 firms) of the sample is highly conservative; out of these 76% (65 firms) showed least earning management (Earning management<Q1) while 24% (21 firms) showed moderate earning management (Q1<Earning management<Q3). On the other hand, in the least conservative group, 71% (57 firms) showed high earning management (Earning management > Q3) and 29% (23 firms) showed earning management at a moderate level (Q1<Earning management<Q3). Thus the findings of the study reveal a negative association between accounting conservatism and earning management.

Also**,** Hamdan, (2017) explores the role of accounting conservatism in the relationship between ownership structure and firm performance. The sample of the study consisted of 215 firms from six GCC countries during the period 2013–2015 in gulf corporation council firms. Ownership structure has been determined through three dimensions: ownership concentration, managerial ownership, and institutional ownership. As for performance, it was measured by two variables: return on assets (ROA) and Tobin’s Q.

The study used a panel regression and concluded that accounting conservatism plays a positive role in reducing the negative impact of ownership concentration on firm performance and the positive role of managerial and institutional ownerships is consolidated in firm performance. The accounting conservatism increase in the financial reports of GCC firms reduced asymmetrical information and the intensity of agency problems, besides providing credibility to investors in financial reports.

Similar study by Zulfikara, Atutib, & Ismailc, (2020) empirically investigates The Mediating Role of Accounting Conservatism on the Influence of Independent Commissioners and Managerial Ownership of Financial Performance.

The population of this research is the manufacturing industry listed on the Indonesia Stock Exchange from 2012 to 2016. The sampling technique uses purposive sampling produced from 174 sets of observational data. Data analysis method used is multiple regressions. The result of the research is that Independent Commissioners and managerial ownership have a direct positive effect on financial performance. Other verification results mediate accounting conservatism on the effect of managerial ownership on financial performance. Meanwhile, accounting conservatism as a mediating variable on the influence of Independent Commissioners on financial performance is not proven.

Although, accounting conservatism and uncertainty in business environments; explained by Hejranijamil, Hejranijamil, & Shekarkhah, (2020). They have used financial data of listed companies in the Tehran stock exchange.

The model which is introduced by Basu (1997) was used to measure accounting conservatism. Business strategy and alertness were considered as two proxies for classifying companies based on their level of uncertainty. Findings shown that companies, that adopted a prospector strategy, applied more conservative methods in their financial reports. This has indicated that facing wider uncertainty results in reporting more conservatively, which could not be said about inert companies.

Hence, Chen, Li, & Xu, L. (2019), investigated Universal demand laws and the monitoring device role of accounting conservatism. They make attempts in answering accounting conservatism can serve as an effective monitoring device by exploiting staggered enactments of the universal demand (UD) laws in 23 U.S. states. UD laws take up procedural hurdles for shareholders to file derivative lawsuits against managers and directors who allegedly breach their fiduciary duties. Firms incorporated in states which UD laws were adopted, restrictions on shareholder litigation rights shift power to managers, thereby weakening directors' incentives to monitor managers.

They predict a decrease in conditional conservatism following the enactment of UD laws. The main result is attributable for both the direct channel (through restriction of shareholder litigation rights) and the indirect channel (through the deployment of management-friendly governance provisions). The decline in conditional conservatism exists only for firms with low institutional ownership, low external equity dependence, or high *ex-ante* derivative lawsuit risk.

According to the results we have founded it can be suggested that accounting conservatism cannot be successfully demanded by shareholders when managers own extensive power and directors lack the incentives to monitor managers.

The effective tax rates lead to consequences of, leverage, and litigation costs, company size, institutional ownership, public ownership and the effectiveness of audit committees in accounting conservatism at public companies LQ45, explained by Thomas, & Aryusmar (2020).

The taken data is from financial statements presented on the Indonesia Stock Exchange in 2013-2018. The obtained sample was from a sample of 24 companies with certain criteria from 45 LQ45 public companies. Eviews10 is used in Panel data processing to obtain the fixed effect regression equation, t test (partial) and the sensitivity of the effect on public companies (individuals). The results has shown that accounting conservatism was significantly affected by litigation costs (-), company size (+), public ownership (+) and audit committee effectiveness. Accounting conservatism is not affected by variables effective tax rate, leverage and institutional ownership. The highest positive sensitive effect was on BBNI and the lowest sensitive was on ADRO while the highest negative sensitive influence was on UNVR and the lowest sensitive was on PGAS. Therefore, the quality of corporate financial reporting can be improved by this research**.**

Nevertheless, the determination elements of accounting conservatism on manufacturing companies in Indonesia investigated by Sugiarto, & Fachrurrozie (2018). The aim of this research is to examine the influence of financial distress, leverage, investment Opportunity set (IOS), and managerial ownership to accounting conservatism.

The populations of this research were 143 manufacturing companies that listed in Indonesia Stock Exchange (IDX) for year 2013-2016. Technique to collect the sample was purposive sampling, and obtained 20 samples and 80 unit of analysis. The research used multiple regression analysis method by IBM SPSS 23. The result showed that financial distress and leverage significantly have positive influence towards accounting conservatism. Investment opportunity set (IOS) does not have influence towards accounting conservatism. Managerial ownership significantly has negative influence on accounting conservatism. Based on the research results, it can be concluded that financial distress and leverage can increase the implementation of accounting conservatism. While, managerial ownership can decrease the implementation of accounting conservatism.

Nevertheless, Alves, S. (2019) explained Ownership Concentration and Accounting Conservatism. Existing literature suggest that conservatism is related to ownership structure. The structure of the Portuguese governance is characterized by the largest shareholder which are the dominant and who typically exercises significant influences on management decisions directly or indirectly. Therefore, for a sample of 26 non-financial listed Portuguese firms-years from 2002 to 2016, they examine the association between accounting conservatism and ownership concentration. The study’s results suggest that ownership concentration demand for more conservatism. The results also suggest that higher leverage and large firms have a greater demand for conservative accounting.

By Mohammed. Ahmed, & Ji, X. D. (2017), Accounting conservatism, corporate governance and political connections have been explained**.** The objective is to test the relationship between accounting conservatism, corporate governance and political connection in listed firms in Malaysia where political influence plays a significant role in the capital market and in many business dealings.

824 firm-year have been utilized in observations comprising large listed companies over a period of four years from 2004, this study uses ordinary least squares regression models to investigate this relationship.

The results show evidence of accounting conservatism in Malaysia. Further, the results reveal that corporate governance structure which is better in terms of board independence is positively associated with accounting conservatism while management ownership is negatively associated with it. However, political connection puts a negative moderating effect on the positive relationship between accounting conservatism and board independence. The results also suggest a positive association of political connections with firm’s future performance.

The Role of Debt Covenant in Moderating the Effects of Political Cost on Accounting Conservatism have been explained by Basar, Nusantara & Hendro. Mainly objective of this study was to analyze the direct effect of political cost and debt covenant on accounting conservatism. Besides, this study also analyzes the debt covenants role as a moderator concerning the effects of political cost on accounting conservatism. The samples companies that are companies which indexed on the IDX30 other than financial services companies and companies with non-rupiah financial reports. The data used is secondary data from the financial statements of 20 companies listed on the Indonesian stock exchange, Data analysis using multiple linear regression and analysis of variance.

Next, implementation of accounting conservatism has been showed by Permatasari, & Yulianto, (2020). The results showed that accounting conservatism is directly affected by political cost positively and significantly. Whereas, accounting conservatism is not directly affected by debt covenant that can be significant, besides, this study shows the role of debt covenants in strengthening the effect of political costs on accounting conservatism.

Shen, Ho, Yang, & Wang, (2020), explain corporate social responsibility, market reaction and accounting conservatism. The authors investigate the connection between corporate social responsibilities (CSR) and accounting conservatism and also look into channels through which such effects are transmitted. The aim of this paper is to make a research about how CSR, as non-financial information that has received widespread attention, affects choices regarding corporate financial policy

The results show how non-financial information influenced firms’ financial policy. In addition, the results verify the attraction of liquidity and investor attention as the major market reaction channels in so far as that CSR significantly promotes accounting conservatism. Moreover, other critical paths of influence deserve further exploration. The results remain robust for alternate measures of accounting conservatism, different components of CSR, and other proxies on CSR, endogenous testing and alternate estimation methods.

Muslim 2019 investigates bondholder-shareholder conflict in the banking industry in Indonesia. The banking industry has a high complexity, a large information risk, contractual differences, and strict regulations that result in the high possibility of applying conservative accounting (Hsu, Novoselov, & Wang, 2017). This study uses panel data and multiple regressions. Samples were taken from the banking financial statements in Indonesia from the Jakarta Stock Exchange in the 2016-2018 periods by using purposive sampling under criteria of including the availability of complete financial statements, and from the banking sector industry. By using 66 observations, they found that first; bondholder conflict was related to accounting conservatism through two proxies, STDROA and LEV. Second, through the Basu coefficient they found that the banking industry in Indonesia adopted accounting conservatism. Third, bond-holder conflicts and accounting conservatism in the banking industry can only be proven through dividend and leverage policies.

Accounting conservatism and corporate social responsibility have been explored by Anagnostopoulou, Tsekrekos, & Voulgaris, (2020).

They were going to examine whether a firm's stakeholder orientation, as manifested by its social responsibility endeavors, matters for its choice of accounting conservatism. They explain that the level of conservatism in financial reporting significantly increases with socially responsible activities. This result is considered to be robust to several conservatism aspects, including market-based conservatism measure, the aggregate of R&D reserves, advertising reserves, and LIFO reserves, and accrual-based conservatism construct. Moreover, our two-stage regressive results show the validity of conservatism to be more pronounced for firms that devote more resources to social responsibility programs. The theory of being consistent with stakeholder, these findings indicate that CSR-oriented firms are more likely to use accounting conservatism to credibly commit to acting in the interests of stakeholders. As a whole, our results provide a novel implication accounting conservatism.

Accounting conservatism is defined as "*the accountant's tendency to require a higher degree of verification to recognize good news as gains than to recognize bad news as losses*" (Basu, 1997). According to Ross L Watts (2003), an extreme form of conservatism can be expressed by a saying that "anticipate no profits, but anticipate all losses." Conservatism can also be referred to as prudence concept (Lin, Wu, Fang, & Wun, 2014). A higher level of confirmation is required in order to recognize profits as compared to expenses. Profits should be recognized after verification at a greater level as compared to expenses (Ross, 2003), accounting conservatism results in more timely recognition of expenses and losses as compared to gains and incomes (Givoly et al., 2007). Conservatism has affected the accounting practice for at least five centuries (Basu, 1997). Ross L.Watts (2003) suggests that accounting practice has become more conservative especially in the last three decades.

Accounting conservatism is categorized one of the most important properties of financial reporting. The target of this article is to gain a better understanding of accounting conservatism. We illustrate the evolution of conservatism over its long history. Accounting conservatism is an indispensable element because the main parties of a firm demand conservatism to mitigate agency costs. Accounting conservatism is measured by using various methods, which include balance sheet measures, income statement measures and earnings/stock return relation measures. Experimental research into accounting conservatism has flourished over the last two decades and we focus on the cross-sectional and time-series variations in conservatism. We conclude that accounting conservatism is significant and cannot be excluded from accounting standards.

3. METHODOLOGY

Form output of the reviewed articles it can be that principle of conservatism is an earning management tool employed by board of directors to maximize shareholder interest. With this regard there are firms conduct highly conservatism ashier are many others which is least conservatism and some others with moderate conservatism. Also, Conservatism roles in the relation between ownership structure and firm performance explained. Conservatism accounting lead to minimizing negative impact of ownership concentration of firm performance and consolidates the positive role managerial and institutional ownership in firm performance, and help to reduce, asymmetrical information, this will maintain high quality of financial statements. Also, its common to be more conservative while we adapt strategy based on uncertainly. Finally this lead to wider uncertainty in reporting then one study come out with that explanation that conservatism weakling directors desire to control managers. Next, accounting conservatism significantly affects litigation cost (-), company size (+), public ownership (+) and audit committee effectiveness, While each of tax rate and leverage isn't influence accounting conservatism. Form body text of the reviewed papers it is clear to predict distinctive result. Some explain positive, while others explain a negative result. For instance sugiarto / fachrurrozie 2018 explain a positive effect 2020. But a uniform result could be noted regarding management ownership and conservatism, among scholars.

From the reviewed papers in the academic work, quite easily we could see there are distinctive and not similar findings. Many explain high degree of verification before any recognition of revenue negatively related to the firm's net income (earnings). This is quite understood because under accounting conservatism principle any liabilities as soon as recognize in contrast revenue are being recorded after verification process on the hand uncertain or probable losses are recorded, in such cases firms facing shortage in earnings. Even though in a specific circumstances firms report low net income but in long run performance it would be quite beneficial. For instance, low report of income encourages managers to be more aware in its managements. But from result of study by chexu 2019, explain conservatism principle lead to weakening monitor by the managers. The interpretation of this conclusion is that because managers reported liabilities and losses as soon as thus, it doesn't need any concern any more. karvet (2014) found there is negative connection between managers policy management and accounting conservatism, when making risky investments, he arrived that conservatism decrease the managerial incentives in making riskier investments. With regard in one article explained that banks are much interested in employing accounting conservatism, This result quite common and confirmed by many other findings (ball, robin, and sadka 2008) in their finding explain debt market are known for more conservatism than equity markets.

4. CONCLUSION

The paper study current of accounting conservatism and its impacts on firm's value reviewed of 15 studies from distinctive countries observed and they depict; in many cases being conservatism have positive impact, while from many others draw a negative conclusion to firm's profitability. Also under conservatism owners being concentrated and asked for more leverage, also, plays a positive role in reducing the negative impact of ownership concentration on firm performance. Despite that it would be quite good for governance activity. Then in case of financial distress the demand for being conservative quite high. Nevertheless, uncertain result in financial reporting many occur while firm's books for high certainty, undoubtedly this will lead to lower income (profit) and mislead or distort investor decision. Finally, business environment being affected by accounting conservatism, this is because adapted strategy led to conservative approach in financial reports, being more alert toward business environment results to uncertainty and which could not be said about inert companies.

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