

THE EFFECT OF THE ACCOUNTING CONSERVATISM ON REDUCING INFORMATION ASYMMETRY AND THE COST OF CAPITAL WITHIN THE FRAMEWORK OF INTERNATIONAL STANDARDS

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Abstract

Accounting conservatism principle plays an important role in producing fair view of financial statements and has appeared as one of the most prominent research topics over the last 15 years. The main objective of this study is to determine the effect of the accounting reservation to reduce the asymmetry of information and the cost of capital within the framework of international standards (IFRS). To achieve the objectives of the paper, the researcher relied on reviewing 14 related studies that were published in different journals and by different authors for time periods (2015-2020). Based on the results of the aforementioned studies, the study reached several results, the most important of which is that accounting conservative has a major role in reducing the phenomenon of asymmetry of information and reduce the cost of capital within the framework of international standards (IFRS) through the commitment in the Stock Exchange listed companies to apply international standards that are conservative accounting to improve their efficiency.

Keywords: *Accounting Reservation, Asymmetry of Information, Cost of Capital, International Standards (IFRS).*

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1. Introduction

Accounting reservation represents an evolution of the principle of prudence and caution, which has won wide acceptance among accountants for several years, and was directed towards influencing the financial statements. It takes into account the expected decline in income or assets before their realization (Sabir, 2022). The recognition of the occurrence of the increase in these two elements is postponed at the time of making sure that it is actually reducing, and this principle is still controversial until now because of its direct and indirect impact on the credibility and transparency of the financial statements,

as the accounting reservation represents the choice of accounting methods and policies made available by international standards (Rashid, 2020). To prepare financial reports (IFRS) to report lower values of assets, revenues, and higher values of liabilities and expenses, which results in a decrease in the net book value of the right of ownership over the market value, and this does not mean showing the value of assets at less than their actual value, but estimating them at the lowest marginal value and there is still a trend among standard setters (Sabir, 2022). International Financial Reporting (IFR) works towards adhering to the accounting reservation to reduce management's motivation to manipulate accounting profits and conceal important and necessary information from investors, as well as mitigate the negative repercussions of asymmetry of information by helping investors monitor management and reduce information blocking, as the accounting reservation contributes to enhancing the credibility of financial statements (Rashid, 2017). And increase the level of relevance of the information for assessing assets and IRR Equipment, liabilities and losses (Jaf, 2015). Consequently, there will be a reduction in the asymmetry of information and the cost of capital, allowing investors to identify successful investments and differentiate between investment alternatives available in the capital market, enabling them to estimate the risks and returns involved in investments and make a rational investment decision (Rashid, 2018). The accounting reservation has also become a basic factor at the present time, especially after the collapse of many international companies, and the users of financial reports questioned the information contained in these reports and their quality. Rashwan, (2017).

2. Literature Review

The study aims to examine the correlation between accounting conservatism and the efficiency of investment decisions in view of managerial ownership variance which is regarded as one of the main principles of determining investment decisions efficiency. A model was designed based on the consideration that accounting conservatism represents the independent variable, while the investment decisions efficiency represents the dependent variable. The research measured the accounting conservatism in the companies of the sample by using basu scale (1997); while using Biddle ET. Al (2009) model to measure the dependent variable. To achieve the objective of the study, the study tested the hypothesis by implementing the designed model but with different levels of managerial ownership on a sample of 87 Jordanian companies from 2013 to 2017. The

results of the study supported its hypothesis; as it showed the existence of different correlations between accounting conservatism and investment efficiency decisions according to the difference in the ratio of managerial ownership. The results also revealed that in conservative companies, the efficiency of investment decisions depended on the level of marginal conservatism, which differs from one managerial ownership level to another. Moreover, the study proposes what the research named as ‘The Marginal Level of Conservative Benefit’, which resulted as a consequence of the correlation between conservatism and managers’ motivation (Ali Al-fadhel, 2020).

The paper examines the relationship between accounting conservatism and information asymmetry. Investment decisions are facilitated when the relevant information is available to the decision makers. The information could be firm specific or macroeconomic information. Concerning accounting information, the value relevance literature is concerned with investigating the nexus between a particular accounting number and stock values to provide an assessment of those numbers’ use. Conservatism in accounting has the intention to guide management in preparing financial reports in the face of uncertainty as a cautious reaction to the adequate consideration of uncertainty and risk inherent in business situations. How conservative impacts on information asymmetry has in recent times attracted intellectual discourse. This paper contributes to this blossoming line of research by examining the arguments in the literature on conservatism, quality of financial statements and information asymmetry. On the one hand, some have argued that conservatism results in reporting lower net income and future benefit thus leading to revenue shifting; as current period will be understated and future periods overstated. Therefore, firms could have difficulty tracking business operations internally and as such accentuate information asymmetry (Odia, 2018).

Study aims in general to identify the impact of the accounting reservation to reduce the asymmetry of information and the cost of capital within the framework of international standards (IFRS), and to answer questions and test hypotheses, rely researcher on the descriptive and analytical approach in showing and clarify the theoretical side through previous studies, journals and letters scientific, and analyze the results of the field study and test hypotheses using statistical program (SPSS). Questionnaire it was also distributed after evaluated and judged by a number of specialists on a sample consisting of directors and heads of departments and accountants

and financial personnel departments listed companies in Palestine Stock Exchange's study (155) single. The results of the field study also proved that there are a trace of the accounting reservation in reducing the phenomenon of asymmetry of information and reduce the cost of capital within the framework of international standards (IFRS). The study also recommended the need for more commitment in the Palestine Stock Exchange listed companies to apply international standards that are conservative accounting to improve their efficiency (Rashwan, 2017).

The study aims to investigate the moderating role of accounting conservatism in the relation between ownership structure and firm performance of Gulf Cooperation Council (GCC) firms. The sample of the study consisted of 215 firms from six GCC countries during the period 2013–2015. Ownership structure was 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 consolidate the positive role of managerial and institutional ownerships in firm performance. The increase of accounting conservatism in the financial reports of GCC firms reduced asymmetrical information and the intensity of agency problems, besides providing credibility to investors in financial reports (Hamdan, 2017).

The purpose of this study is to determine the factors influencing the accounting conservatism for banks in the UAE over the period 2006-2013. Design/methodology/approach – Multiple regression analysis is used to test the relationship between accounting conservatism as a dependent variable and the independent variables intellectual capital performance, market structure, level of protection against risk, bank size, and bank profitability. The results indicate that intellectual capital performance, market structure, bank size, the level of protection against risk and bank profitability have significant impact on the accounting conservatism for banks in the UAE. These results might help the banking and accounting regulators to address the factors affecting accounting conservatism. This study adds to the literature on the determinants of accounting conservatism in banks. In particular, it tests whether the new theories of intellectual capital performance, market structure and

level of protection against risk have an impact on accounting conservatism in the banking industry in the UAE (El-Bannany, 2017).

This study examines the effect of conditional accounting conservatism on the information asymmetry on a sample of listed service firms in Arab Financial Markets. This paper is based on Khan & Watts (2009) model to measure the level of conservatism, and on the High-Low Spread to measure Information Asymmetry. Data is collected using the annual financial statements and trading bulletins from 2007 to 2015. The Results show that the studied companies applied conditional conservatism practices, and following accounting conservatism practices reduce the Information Asymmetry. These results indicate to the importance of accounting conservatism in increasing the decision usefulness for investors, which appear in contradictory with removing conservatism from the accounting conceptual framework as undesirable characteristic (Altawel, 2017).

This study aimed at clarifying the relationship between the IFRS standards and the investment decision from the point of view of current and prospective investors because they are the owners of the risk capital, and they affect the decisions of the economic unit through the right to vote, and measuring the effect of the accounting conservatism through measures of the risk of accounting information. And the impact of the use of the fair value criterion as one of the IFRS standards on the accounting conservatism and the investment decision. The study concluded with the development of an accounting approach that contributes to the rationalization of the investor's current and prospective decision towards companies whose shares are traded on the Egyptian Stock Exchange. This approach was applied to the sector (industrial products and services and vehicles) before and after the adoption of IFRS standards in order to determine the effect of the accounting reserve before and after the application of these standards. The study recommends further application of the proposed accounting approach to more sectors and other industrial, service, financial or non-financial companies, as well as the necessity of activating the supervisory and supervisory role of the Egyptian Capital Market Authority in monitoring the published financial statements of listed companies in the Egyptian Stock Exchange (Mahmud Al – Adli, 2017).

This study aimed at measuring the accounting Conservatism for the industrial Jordanian joint stock companies through applying Basu's, 1997, model. The study relied on the analytical descriptive method in the data collection process, which are represented

in the financial lists of the industrial Jordanian joint stock companies from the period 2008- 2014. The population consisted of all joint stock industrial Jordanian joint stock companies that are listed in Amman Stock Exchange (N= 77 companies). The sample included (59) companies representing (76%) of the population. The study reached to a set of results most important, namely his large effect of accounting reservation on the accounting information which is reflected on the taken decisions in light of such information resulted in an increase of the accounting research especially during the last decade. This accounting reservation is considered among the important principles that affect the consistency and accuracy of accounting information listed in the financial lists. However, there are various reasons that caused the interest of scholars in the accounting reservation, including the need to have more conservatism financial lists to insure the existence of profit management practices in the financial reports, the increase of debate about the use of the fair value in evaluating the assets which indicate to the need to disclose thereof when taking consultation decisions (Hamdan & Al-Qudah, 2016).

This paper examines the effect of accounting conservatism on firm-level investment during the 2007–2008 global financial crisis. Using a differences-in-differences design, we find that firms with less conservative financial reporting experienced a sharper decline in investment activity following the onset of the crisis compared to firms with more conservative financial reporting. This relationship was stronger for firms that were financially constrained, faced greater external financing needs, or had higher information asymmetry. We also find that more conservative firms experienced lower declines in both debt-raising activity and stock performance. The evidence suggests that accounting conservatism reduces underinvestment in the presence of information frictions (Balakrishnan *et al.*, 2016).

This study examines how companies voluntarily change their financial reporting conservatism in response to an exogenous decrease in analyst coverage. This paper hypothesize that more severe information asymmetry and weaker external monitoring associated with such a decrease in analyst coverage exacerbate agency conflicts between contracting parties, which in turn creates a greater demand for conservative accounting. Consistent with this prediction, we document a significant increase in accounting conservatism following an exogenous drop in analyst coverage. Furthermore, the effect is stronger when the dropped analyst is more informed and when the affected firm has a

higher financial leverage ratio, less favorable credit ratings, and a higher proportion of cash-based CEO compensation. The overall evidence is consistent with the notion that accounting conservatism arises as part of the efficient technology employed by firms to address agency problems between contracting parties (Shi & You, 2016).

This paper reviews the conservatism of earnings and cost of equity to enhancement and improvement of quality information pertaining to earnings quality that leads to the reduction of information asymmetry (information risk) and consequently reduces cost of equity. Review of this paper suggests that managers should disclose more quality information particularly related to earnings in order to increase investor's willingness to invest in capital market. Therefore, this paper intends to resolve the issue of information asymmetry by determining the role of conservatism of earnings on cost of equity (Sofian *et al.*, 2016).

The study aimed to shed light on the debate of the effects of increased monitoring on firms' investment policies by studying the association between accounting conservatism and firm investment efficiency. The study hypothesize that conservatism has a significant informational role that results in improvements to firm investment efficiency. In particular, we expect conservatism influences firm investment efficiency in three main ways. The study finds that conservatism enhances investment efficiency by contributing to reduce both over- and under-investment. Specifically, firms with higher conservatism invest less (more) in years when there are signs of over- (under-) investment in the whole economy, the industry of reference and at the firm-specific level. The results are robust to the inclusion of multiple control variables and to the use of alternative measures of investment. Second, we find that conservatism decreases investment among firms with free cash flow problems, and increases investment amongst those that face financing constraints, as measured by high leverage. Overall, these results are consistent with conservatism reducing under-investment by facilitating access to external funding (Lara *et al.*, 2016).

The study investigates the relation between conditional conservatism in financial reporting and future stock price crash risk. Using a large sample of firm-years over the period 1964–2007, we find that the degree of conditional conservatism (i.e., timelier recognition of bad news as losses than of good news as gains) is significantly and negatively associated with future crash risk. This result holds after controlling for

investor heterogeneity, information opaqueness, and other firm-specific factors deemed to cause large negative return outliers. Our results are robust to the use of different measures of crash risk and conservatism, alternative model specifications, and a variety of sensitivity checks. In addition, we find that the predictive power of conservatism with respect to future crash risk is more pronounced for firms with higher information asymmetry, namely, those with relatively higher R&D investments, higher industry concentration, and lower analyst coverage. Study results are consistent with the notion that accounting conservatism is associated with less withholding of bad news or the more timely release of bad news to outside investors, thereby reducing stock price crash risk. Plafond and Watts (2008) provide evidence that conservatism plays an important role in the equity market by reducing information asymmetry. Our study complements theirs by providing evidence on one benefit of conservatism in the equity market through the reduction of future crash risk. Our research has implications for standard setting bodies, such as the FASB and IASB, which recently eliminated conservatism from their conceptual framework (Kim & Zhang, 2016).

The objective of study to examine how conditional conservatism affects the cost of equity via the effects of information precision (i.e., more precisely revealing bad news) and information asymmetry. Using accounting-based conditional conservatism proxies, however, we find a significantly *positive* association between conditional conservatism and the cost of equity. This positive relation operates via improving information precision about negative earnings shocks and generally inflating information asymmetry among investors, both of which increase the cost of equity. We further find that the cost of equity effect of conditional conservatism disappears in the period after the enactment of the Sarbanes-Oxley Act (SOX), consistent with the notion that nationwide improvement of information precision about negative news and diminished information asymmetry are engendered by the SOX regulation. This study adds to researches on conditional conservatism, SOX, and the cost of equity, and also has policy implications (Biddle *et al.*, 2015).

3. Discussion and Conclusion

The above research papers confirm the fact the accounting reservation is a basic factor at the present time, especially after the collapse of many international companies, and the users of financial reports questioned the information contained in these reports and their

quality and this principle is still controversial until now because of its direct and indirect impact on the credibility and transparency of the financial statements, as the accounting reservation represents the choice of accounting methods and policies made available by international standards (Rashid, 2019). Based on the above, the main objective of this study is to determine the effect of the accounting reservation to reduce the asymmetry of information and the cost of capital within the framework of international standards (IFRS). And that is through the researcher relied on reviewing 14 related studies that were published in different journals and by different authors for time periods (2015 - 2020).

The main limitation of current paper was time, cost, and not available some related source (Mustafa *et al.*, 2022). Finally, the study reached a number of results based on the aforesaid studies, the most important of which is found that adherence to international standards and accounting conservatism contribute to increasing the quality and continuity of profits and the ability of shareholders to forecast future cash flows on the one hand and increase the level of relevance, reliability and quality of financial information by reducing information asymmetry and on the other hand, as well as increasing investments in the company to match the information provided to investors (Jaf *et al.*, 2019 and Rashid, 2020). Based on the above the study recommends the need for more commitment by companies listed on the stock market that is characterized by accounting conservatism to improve the efficiency of their performance and maintain their value, as well as to do more accounting conservatism to reduce the asymmetry of information and spare the risk of its dissemination between contracting parties associated with the company.

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