WHERE DID CONSERVATISM GO?

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ABSTRACT

Conservatism in financial reporting has existed for a long time. This paper reviews some of the historical background on and the evolution of conservatism. Even though conservatism has disappeared as an acceptable convention in FASB conceptual literature, it still exists, both in terms of its inclusion in accounting standards and in terms of discretionary application. Questions are raised since accounting standard setters seem to be moving away from conservatism even though arguments exist that contracting, litigation, and regulation issues would normally lead to the use of conservatism.

INTRODUCTION

Conservatism in financial reporting has existed for a long time. It has sometimes been implicitly incorporated into accounting standards, sometimes in accounting and financial reporting through professional judgment. While recognizing its existence, caution has been expressed about it from times at least as early as the Committee on Accounting Procedure (CAP) in 1939 [3]. Conservatism was addressed by the Accounting Principles Board (APB) [5]. A significant discussion of conservatism was included in Financial Accounting Standards Board (FASB) Statements of Financial Accounting Concepts Statement (SFAC) 2 [11]. However, when that statement was superseded by SFAC 8 [16], conservatism was no longer discussed except in the background information.

This paper will review some of the historical background on conservatism, focusing on its appearance in documents from accounting standard setting bodies. The evolution of conservatism in both conceptual statements from standard setters and actual accounting standards will be discussed. Even though conservatism has disappeared as an acceptable convention in FASB conceptual literature, it still exists, both in accounting standards and in discretionary application. Questions are raised since accounting standard setters seem to be moving away from conservatism even though there are arguments that contracting, litigation, and regulation issues would normally lead to the use of conservatism.

RESEARCH BACKGROUND

Basu [7] reports evidence that conservatism in accounting has existed for several centuries. He interprets conservatism as "denoting accountants' tendency to require a higher degree of verification to recognize good news as gains than to recognize bad news as losses" [p. 7]. Conservatism continues to exist in our accounting and financial reporting, sometimes through the use of existing accounting standards, sometimes through the use of professional judgment exercised by accounting professionals. This is true even though standard setting bodies have clearly expressed concern about conservatism. In fact, evidence exists to show that conservatism has actually increased in recent decades [18][25][26].

Research on conservatism continues to be published, oftentimes including different measures of conservatism that have been tested [18][20][21][24]. Distinctions have been made between

unconditional and conditional conservatism [8][23][25]. Beaver and Ryan [8] describe unconditional conservatism—"the book value of net assets is understated due to predetermined aspects of the accounting process"—and conditional conservatism—"book value is written down under sufficiently adverse circumstances, but not up under favorable circumstances."

Lawrence, et. al. [22] provide a different distinction—mandatory conservatism versus discretionary conservatism. They cite several articles documenting that "various economic incentives induce cross-sectional variation in managers' discretionary application of conservatism" [p. 2]. They then discuss the results of their study which show that "mandatorily conservative accounting is a significant determinant of cross-sectional variation in conditionally conservative accounting" [p. 2] and that including mandatorily conservative accounting in their model shows that some of the incentives for discretionary conservatism discussed in previous papers become insignificant or weakened. The next section will follow the conceptual development of conservatism through modern-day standard setting bodies in the U.S.—from recognition and warning to implicit acceptance to explicit exclusion.

CONSERVATISM: A CONCEPTUAL VIEW FROM ACCOUNTING STANDARD SETTERS

Centuries-old records show that accounting in medieval Europe had some basis in conservatism [7]. These origins related to a conservative reflection of assets on the balance sheet, but Basu [7] states that the emphasis in financial accounting since the mid-1930s has been on the income statement. Because of this emphasis, conservatism in the income statement took on greater significance as well. The CAP of the American Institute of Accountants (AIA) was the first private body in the U.S. for setting accounting standards. Although its Accounting Research Bulletins (ARBs) did not have a binding impact on financial reporting, these bulletins were a step toward the standardization of accounting.

The first three ARBs, all dated September 1939, include comments about conservatism [1][2][3]. The first bulletin discussed the "increased recognition of the significance of the income statement, with a resulting increase in the importance attached to conservatism in the statement of income, and a tendency to restrict narrowly charges to earned surplus" [1, p. 2]. The second bulletin argued "that conservatism in the balance-sheet is of dubious value if attained only at the expense of a lack of conservatism in the income account, which is far more significant" [2, p. 13]. The third bulletin warned against excessive understatement in the value of assets under quasi-reorganizations. Such understatement, "though it may result in conservatism in the balance-sheet at that date, may also result in overstatement of earnings or of earned surplus when the assets are subsequently realized" [3, p. 26]. Therefore, the argument was made that the revalued assets should be carried at "a fair and not unduly conservative value" [3, p. 26].

In its efforts, the CAP did not seem to identify, define, and describe any conceptual basis for accounting standards. Rather it was an attempt to deal with specific circumstances without developing a cohesive set of objectives, definitions, and characteristics for accounting and financial reporting. The APB, a committee of the American Institute of Certified Public Accountants (formerly AIA), succeeded the CAP as the private-sector accounting standard setting body in 1959. The APB issued 31 opinions and four statements. Statement 4, issued in October 1970, was entitled, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises" [5]. This statement essentially provided a conceptual basis for accounting principles and standards. It included a discussion of financial statements, a description of the basic features and elements of financial accounting, an overview of the environment of financial accounting, a statement of the objectives of financial accounting and financial statements, and an outline of some generally accepted accounting principles. Chapter 6 of this statement discusses generally accepted accounting principles. After addressing the

pervasive principles, some modifying conventions are discussed. The first of these modifying conventions is conservatism. Paragraph 171 defines and describes conservatism as follows:

> Frequently, assets and liabilities are measured in a context of significant uncertainties. Historically, managers, investors, and accountants have generally preferred that possible errors in measurement be in the direction of understatement rather than overstatement of net income and net assets. This has led to the convention of conservatism, which is expressed in rules adopted by the profession as a whole such as the rules that inventory should be measured at the lower of cost and market and that accrued net losses should be recognized on firm purchase commitments for goods for inventory. These rules may result in stating net income and net assets at amounts lower than would otherwise result from applying the pervasive measurement principles [5, p. 66].

Conservatism is also discussed elsewhere in Statement 4. In a section which includes descriptions of several terms, the concept of conservatism is described as follows: "The uncertainties that surround the preparation of financial statements are reflected in a general tendency toward early recognition of unfavorable events and minimization of the amount of net assets and net income" [5, p. 15]. The APB explicitly recognized conservatism as a convention applicable to some circumstances in financial reporting. It provided a fairly specific description of conservatism and gave some examples where generally accepted accounting principles had incorporated conservatism. Three years after the APB finalized Statement 4, the FASB became the new private-sector accounting standard setting body.

In addition to beginning work on Statements of Financial Accounting Standards (SFAS), the first one of which was issued in December of 1973, the FASB began work on a conceptual framework for accounting. The conceptual framework project has resulted in eight different SFAC. The first concept statement was issued in 1978 and addressed the objectives of financial reporting, specifically for business enterprises. In 1980, FASB issued SFAC 2, titled, "Qualitative Characteristics of Accounting Information" [11]. This statement included a chart with a hierarchy of accounting qualities. It defined the primary decision-specific qualities that make information useful to decision makers: relevance and reliability. It also showed the ingredients of relevance (predictive value, feedback value, timeliness) and reliability (verifiability, representational faithfulness, and neutrality). The chart also illustrated comparability (including consistency) as a secondary and interactive quality of useful information. Each of these concepts is discussed in the textual paragraphs of the statement. In addition to a discussion of these concepts, conservatism is also afforded 7 paragraphs, a fairly significant number considering the entire statement, including appendices, has 166 paragraphs. Parts of these paragraphs are relevant in explaining the development of conservatism as a conceptual concept in accounting.

The first of these seven paragraphs recognizes that conservatism is "a convention that many accountants believe to be appropriate in making accounting decisions" [11, para. 91]. The second paragraph mentions that because of uncertainty in accounting, conservatism has a place in financial reporting but that the convention must be applied with care and that it can conflict with stated qualitative characteristics of accounting information such as representational faithfulness, neutrality, and comparability [11, para. 92]. The third paragraph gives a little history that conservatism was very prevalent when the key external users of financial statements were bankers and other lenders and when the balance sheet was the primary financial statement because understatements of assets meant a greater margin of safety for these lenders. However, recognizing that conservatism is widely accepted in spite of efforts over 40 years to change that view, the first sentence says the following: "Conservatism in financial reporting should no longer connote deliberate, consistent understatement of net assets and profits" [11, para. 93].

The fourth paragraph gives recognition to the fact that understated assets often lead to overstated income in future periods and that the conservatism in income cannot be sustained [11, para. 94]. The fifth paragraph indicates that conservatism is a prudent reaction to uncertainty and that if two different amounts that could be recorded are equally likely, the less optimistic estimate should be used. However, it also states that "conservatism no longer requires deferring recognition of income beyond the time that adequate evidence of its existence becomes available or justifies recognizing losses before there is adequate evidence that they have been incurred" [11, para. 95]. The sixth paragraph states that consistent understatement will "raise questions about the reliability and the integrity of information" but also states that imprudent reporting is also inconsistent with the objectives of financial reporting. This paragraph concludes with two important statements. "Bias in estimating components of earnings, whether overly conservative or unconservative, usually influences the timing of earnings or losses rather than their aggregate amount. As a result, unjustified excesses in either direction may mislead one group of investors to the possible benefit or detriment of others" [11, para. 96]. The seventh paragraph mentions that appropriate disclosure of the nature and extent of uncertainties will allow financial statement users to form their own opinions about the events and transactions recorded [11, para. 97].

While recognizing that conservatism might sometimes be appropriate, SFAC 2 also warns against conservatism for its own sake. This statement indicates that conservatism should not be a deliberate understatement of assets and income and that bias in either direction is inappropriate, possibly misleading varying groups of financial statement users. Since this statement was issued in 1980, significant events have occurred in the world economy, including in accounting and financial reporting. In recent years, the FASB and the International Accounting Standards Board (IASB) have worked on many projects designed to converge accounting concepts and standards. As a result of this convergence process, the FASB issued SFAC 8 [16] in 2010 to replace the first two concepts statements.

Chapter 3 of this statement discusses the qualitative characteristics of useful accounting information. Although there are some similarities between the discussion in SFAC 8 and SFAC 2, there are some important differences as well. SFAC 8 discusses two fundamental qualitative characteristics which make financial information useful: relevance and faithful representation. These two qualities are to be maximized to the extent possible, recognizing that perfection is unlikely. Neutrality is listed as a component of faithful representation. "To be a perfectly faithful representation, a depiction would have three characteristics. It would be *complete*, *neutral*, and *free from error*" [16, para. QC12]. Four other characteristics are presented which can enhance the usefulness of information: comparability, verifiability, timeliness, and understandability.

No mention is made of conservatism in Chapter 3 of SFAC 8. However, it is discussed in the appendix to that chapter which discusses the basis for the conclusions. "Chapter 3 does not include prudence or conservatism as an aspect of faithful representation because including either would be inconsistent with neutrality" [16, para. BC3.27]. The basis for conclusion section did recognize that some respondents to the Discussion Paper and Exposure draft argued for the inclusion of conservatism or prudence. Some of these respondents felt that bias can sometimes provide more relevant information. However, the Board again reiterated that permission to use prudence can lead to bias and that understating assets in one period often leads to overstatement of income in later periods, a result not consistent with neutrality [16]. The Board also recognized that some respondents indicated that neutrality is impossible to achieve and that relevant information must have a purpose, perhaps justifying conservatism in some cases. However, while recognizing that accounting information does influence decision making, the Board stated that it "does not attempt to encourage or predict specific actions of users. If financial information

is biased in a way that encourages users to take or avoid predetermined actions, that information is not neutral" [16, para. BC3.29].

CONSERVATISM: A VIEW OF ACCOUNTING STANDARDS

The FASB's conceptual framework is not considered to be part of accounting's generally accepted accounting principles (GAAP); rather the conceptual framework helps establish the conceptual boundaries which help provide consistency and harmony between standards, both old and new, that comprise GAAP. Even prior to the first official conceptual framework statements released by the FASB, the concept of conservatism existed in standards issued by the FASB and its predecessors. A number of standards have evolved in terms of their conservative nature over time and this evolution appears to mirror the evolution towards the removal of the conservatism concept within the conceptual framework. There appears to be a deliberate move by the FASB away from the historical acceptance and use of conservative accounting practices towards the concept of neutrality.

An argument has been made that FASB-mandated "recognition of formerly off-balance sheet liabilities such as pensions, post-retirement health benefit obligations and environmental liabilities, along with their associated expenses" [7] has increased conservatism in U.S. accounting in recent years. However, a counter argument could be made that these requirements, although resulting in more *conservative* accounting, are not a manifestation of *conservatism*, but a reduction of the lack of neutrality that existed when these liabilities were not disclosed. These requirements can be argued to just add to the faithful representation of reality in accounting. Evidence from the substance of standards issued by the FASB suggests a consistent and persistent move away from conservatism in recent years. The following paragraphs outline some of this evidence.

The accounting for investment securities has seen perhaps the greatest evolution away from conservatism. ARB 43 issued in 1953 provided that investment securities should be recorded at the lower of historical cost or market value under which unrealized market losses were recognized at the balance sheet date, but no such allowance was made for unrealized gains [4]. SFAS 12 was issued in late 1975. Under SFAS 12, the FASB once again required unrealized losses to be recognized in the period of the decline, but now allowed for securities with previous unrealized losses to recover those losses back up the original historical cost. The standard also required disclosure in the notes to the financial statements of current market values of investment security portfolios [10]. In May 1993 the FASB issued SFAS 115 which allowed market values of investment securities to be recorded on the balance sheet thus allowing for both unrealized increases and decreases in securities values. Securities that were held with the intent of selling in the short-term (trading securities) were to be written up or down to their market values with the unrealized gains and losses flowing into net income [13]. The most recent evolution came in the form of SFAS 159 which was issued in 2007. Under SFAS 159, companies have the option to report financial assets at their fair value regardless of the length of time until subsequent sale. Unrealized gains and losses on securities under this fair value option will flow through net income [15].

Goodwill is the excess amount paid for a business above the sum of the identifiable net assets (recorded at fair value). Under ARB 43 (issued 1953), various methods for accounting for goodwill were acceptable including the write-off of the goodwill over a relatively short period of time [4]. In 1970, the APB issued Opinion 17 and determined that goodwill was to be recognized as an intangible asset on the balance sheet and then to be amortized systematically over a period not to exceed 40 years [6]. In 2001, the FASB issued SFAS 142 which removed the goodwill amortization requirement. Under SFAS 142,

goodwill was to be recognized as an indefinite-life intangible asset to remain on the balance sheet until evidence suggests the recorded amount has decreased in value or is otherwise impaired. SFAS 142 also required goodwill to be analyzed annually for potential impairment with any impairment loss being reported in the year of the impairment discovery [14]. In September 2011, the FASB issued an Accounting Standards Update (No. 2011.08) and eliminated the annual impairment review of goodwill. Companies are now required to review goodwill for potential impairment only when qualitative factors suggest that it is "more likely than not" that goodwill is impaired [17].

The accounting for research and development (R&D) costs started with SFAS 2 issued in October 1974. Under SFAS 2, all research and development costs were to be expensed as incurred [9]. In August 1985, however, an exception to this rule was introduced in SFAS 86. Under SFAS 86, software companies could begin capitalizing research and development costs once "technological feasibility" had been achieved [12]. While no additional changes have been made to U.S. GAAP in regards to accounting for research and development costs, in 1998, the IASB issued IAS 38 which allows all companies to capitalize research and development costs once "technological feasibility" has been reached [19]. As U.S. accounting standards and international accounting standards converge, it is conceivable and probably likely that the FASB will adopt this treatment for all companies.

The systematic process towards convergence of U.S. GAAP with International Financial Reporting Standards (IFRS) is well underway. While no one can know for sure what the resulting converged standards will look like, history has suggested that moves will likely be made towards IFRS when it comes to conservatism issues. Currently, U.S. GAAP requires that property, plant, and equipment be recorded and maintained at historical cost with the requirement of periodic write-downs in the event of impairment. However, under IFRS, companies have the option to record and maintain these assets at fair market value, thus allowing for both increases and decreases in value to be reflected.

DISCUSSION AND CONCLUSION

The evidence appears clear that the FASB is intentionally moving accounting standards away from the concept of conservatism and towards the concept of neutrality. Conservatism has existed for centuries without government regulation imposing it on companies, suggesting its existence is driven by something outside of government enforcement. Watts [26] provides evidence that conservatism was driven historically by management contracting and more recently by the presence of shareholder litigation. Now that governmental regulation is pushing companies away from conservatism, will the forces of contracting and litigation that created conservatism in the first place be able to overcome the existing environment and impose conservatism on companies in spite of the opposition by governmental regulations. Watts concludes that "discarding the benefits of conservatism…is a serious error that may prove fatal to the FASB," and that "if the FASB wants to improve financial reporting, it must recognize the importance of verification and the problems that conservatism's asymmetric verification requirement evolved to address." [26, p. 219]. The outcome of this debate is not yet known and will play itself out in the coming years. The purpose of this paper is to provide the reader with an historical perspective on conservatism and the apparent evolution currently happening within the accounting world. What will be the fate of conservatism as we know it in accounting? If conservatism is eliminated, what will be the consequences, if any? Is Watts [26][27] correct and is the financial accounting system in trouble by going down the path away from conservatism? These questions will likely be answered in future research as the changes and their consequences play themselves out.

References are available upon request from Sheldon R. Smith.