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The Role of Accounting Conservatism in a well-functioning Corporate Governance System

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Abstract

This paper analyses accounting related to corporate governance and is organized as follows. The first section deals with understanding the concept of accounting conservatism. In the second section we analyzed the Relevance of Accounting Conservatism in Corporate Governance to the modern corporate world. The third section includes a Case Study on Ericsson, a Swedish Telecommunications company and conservatism in strong governance firms versus weak governance firms. The fourth part is devoted to the conclusion of our research efforts.

From this study, we conclude that there are several reasons to use accounting conservatism in corporate governance and that current empirical evidence indicates that conservatism has increased in the last decades.

The value of β_3 in **Table 1** indicates that there is a positive significant level of conservatism in accounting practices followed by Ericsson. When the dependent variable is earnings (X), the asymmetric timeliness of earnings coefficient **β3** in **Table 2** provides an estimate of the level of conservatism. We observe that strong governance firms are more conservative than weak governance firms (0.13 versus 0.04).

We expect and hypothesize that strong governance structures will tend to favour accounting conservatism more than weak governance structures. However, excessive dependencies on old structures show poor growth that has been since the oil crisis.

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Table of Contents

1. THE CONCEPT OF ACCOUNTING CONSERVATISM 4

2. THE IMPORTANCE OF ACCOUNTING CONSERVATISM IN CORPORATE GOVERNANCE 5
2.1 Accounting Conservatism and the "Corporate Scandals" *8*

3. RELEVANCE OF ACCOUNTING CONSERVATISM IN CORPORATE GOVERNANCE TO THE MODERN CORPORATE WORLD 9

4. CASE STUDY-ERICSSON AND CONSERVATISM IN STRONG GOVERNANCE FIRMS VS. WEAK GOVERNANCE FIRMS 10

5. CONCLUSIONS 12

6. REFERENCES 14

1. The concept of Accounting Conservatism

The concept of conservatism in accounting practices has remained a predominant characteristic of the accounting field for several centuries. However, standard-setters and accountants have heavily criticized the concept of conservatism. In the IASB Framework it also says that following the accounting standards will normally result in accounts that give a "true and fair view". The recent trend against conservatism in favour of the true and fair view could by illustrated by the following quote of a finance professor:

> *"Conservatism is under attack from certain circles. For example, some (including even the FASB) are now suggesting it may be better to abandon conservatism in order to show more unbiased financial statements."*

In this paper the opposite view will be taken, that accounting conservatism is an important aspect of an efficient corporate governance system. Our view will be supported by theory and a case study will be performed to investigate our hypothesis, that there is a positive relationship between a high degree of accounting conservatism and "good" corporate governance.

Sterling called conservatism the most influential principle of valuation in accounting.[1] Conservatism is defined as the differential verifiability required for recognition of profits versus losses. The principle holds that when you are in doubt the accounting alternative that is least likely to overstate assets and income should be chosen.[2]

The conservative accounting method will have an impact both on earnings and net asset value. The effect on earnings will depend on whether the investments are growing, stable or decreasing. Conservative accounting always results in a lower net asset value of the company. Practices that take place to give a lower value of net assets is for example short

[1] Sterling (1970), p. 256.
[2] Schroeder et al (2001), p. 78.

depreciation periods of tangible assets, LIFO inventory methods, overestimations of pensions and warranties and expensing of R&D expenditures.[3]

The principle of conservatism originally gained prominence as a partial offset to the eternal optimism of management and the tendency to overstate financial statements that characterized the first three decades of the 20th century. Many accountants believed that by placing the least favorable alternative valuation on the firm, the users of financial accounting information were less likely to be misled.[4] In recent years the stock market participants have demanded accounts with market values rather than accounting values and hence the principle of conservatism has lost ground. The new IFRS accounting principles apply in Sweden as of May 1st 2005 to Swedish listed companies. These rules demand updated valuations in the entire balance sheet in each quarterly report. Under the new rules Sweden will probably take a step towards less accounting conservatism for the listed companies. The Swedish corporate earning reports for the year 2004 include comments on how the new IFRS-rules will change financial reporting after May 1st and also comparisons to how previous year's accounts would have closed if the new rules had been applied already at the day of closing balances. The reason for the new rules is the adjustment process towards international accounting standards in the EU.

2. The importance of Accounting Conservatism in Corporate Governance

The stock market participants prefer market values, but researchers in corporate governance show several benefits with conservatism and divide them into the following categories:

- Reduction of litigation costs
- Tax optimization
- Regulators asymmetric loss functions
- Contracting[5]

[3] Penman (2004), p. 575.
[4] Schroeder et al (2001), p. 78.
[5] Watts, 2003b.

The first argument for a use of conservatism is that it reduces litigation costs. Conservatism, by understating net assets, reduces the firm's expected litigation costs. However, this argument is not very relevant for Swedish conditions since there is no extensive use of litigation here in contrast to the US.

The second argument for conservatism in accounting could be relevant. If taxation and reporting are linked it is natural that it can cause conservatism in financial reporting. For example by delaying tax payments the present value of those will be lower and consequently result in a higher firm value. This argument could be relevant for Swedish conditions, we think that taxation and reporting are sometimes linked, but no investigation of the Swedish tax system has been made to find out.

Also financial reporting standard-setters and regulators have their own incentives to induce conservative accounting and reporting. Just as there is an asymmetry in litigation costs, there is an asymmetry in regulators' costs. Standard-setters and regulators are more likely to be blamed if firms overstate net assets than if they understate net assets. Conservatism reduces the political costs imposed on standard-setters and regulators. Despite this argument, the recent trend is that standard-setters are in favour of the true and fair view.

Finally, the contracting argument is probably the most important argument for accounting conservatism from a corporate governance point of view. Many contracts between parties to the firm use accounting numbers to reduce agency costs associated with the firm. Those contracts include contracts between the firm and the debtholders and management compensation contracts. The contracting parties want timely information of performance and value of net assets (that is if a performance that generates revenues takes place in a certain time, that event should be included in the accounts for the same time). The problem is that much information that could make relevant measures timely and informative are not easily verified. For example, the expected increase in net cash flows due to new product development is useful information for evaluating a manager's performance. However, there is no legal claim to those future net cash inflow estimates

and the estimates are not verifiable because they often depend on assumptions about the future that experts cannot agree upon. Because they cannot be verified, the estimates are not used in contracts. Hence, verification is necessary for contracting, but the question is then, why is a higher degree of verification required for gains than for losses? Part of the explanation is that the relevant parties to the firm have asymmetric payoffs from the contracts. If the value of the net assets are higher at maturity than expected the debtholders receive no extra compensation, but if they are lower than expected they might receive less than the contracted sum. Hence, the debtholders always gain if the value of a firm's assets is biased downwards. Debtholders gain from conservative net asset values in another aspect. A debt contract often has a debt covenant, meaning that the company is not allowed to pay out too much of the earnings to the shareholders. Net assets valued in a conservative way reduces the likelihood that the shareholders will be favoured at the cost of the debtholders.

The situation is similar when it comes to compensating managers, meaning that the payoff is asymmetric if the profits are overstated. The risk could be that the manager bias the accounts upwards if they have some room to do so. This risk is quite substantial since the manager frequently has more information than the other parties to the firm. For example, the manager likely has better information about the effects of new product development on the future cash flows than the shareholders, auditor or board of directors have. Absent the verification requirement the manager can bias estimates of those future cash flow effects upwards, not only producing large payments under earnings-based compensation plans, but also perhaps leading to negative net present value investments by the firm. It would be difficult to recover excess payments and prove fraud since estimates cannot easily be estimated. Even if fraud could be proven it would be difficult to litigate the person responsible on the excess payments and the loss on negatives present value investments.

Critics of conservatism argue that it leads to future income statements that are not "conservative". For example land that is valued according to conservative principles will at some time (maybe) result in gains and for the period that it occurs the accounts will not be conservative. The critics somehow miss the point because the goal of conservative accounting is not to produce conservative earnings but a conservative value of net assets.

Besides, the alternative to conservative accounting could result in earnings that are even more subjective.

2.1 Accounting Conservatism and the "Corporate Scandals"[6]

Two terms that are related are "accounting" and so called "corporate scandals". Even though we believe that some misuse of the accounting or fraud is an important component to cause a corporate scandal we also believe that a use of a conservative accounting will decrease the risk for a corporate scandal. Two of the most famous corporate scandals, Enron and WorldCom, also illustrate the importance of conservative accounting. For example the event that led to WorldCom's bankruptcy was the announcement of that $3.9 billion of WorldCom's costs of leasing other company's networks having been "improperly" capitalized rather than expensed. The argument for the capitalization was that there was unused capacity that would result in future (unverifiable) business. Verification is a cornerstone in conservative accounting.

In the case of Enron the bonus for the managers depended on the market value of energy-related contracts and derivatives. For a given contract, Enron managers could choose to select either a "bid" price (the price a market-maker is prepared to pay for the contract) or an "ask" price (the price at which a market-maker is prepared to sell the contract). It was up to the corporate managers to decide if the bid or ask price would be used. The Enron managers posted the ask prices that were sometimes as much as eight times the posted bid prices. While such 'ask' prices are unlikely to generate a sale at the end of a period, hence they enable significant over-valuation of contracts. Enron let the compensation depend on market values and as the example shows it easily results in overvaluation.

[6] The examples could be found in Watts 2003b.

3. Relevance of Accounting Conservatism in Corporate Governance to the modern corporate world

The concept of conservatism in accounting practices relating to corporate governance has remained a predominant characteristic of the accounting field for several centuries. There is extensive research[7] according to which one can infer that contracting and litigation consistently contribute to the existence of conservatism, apart from there being sufficient proof that tax and regulatory explanations contribute to accounting conservatism. According to another paper by Watts in the year 2003 different parties to the firm are subject to asymmetric information, asymmetric payoffs, limited liability and varying time horizons[8].

An important benefit of accounting conservatism is that it helps reduce moral hazard problems created by asymmetric payoffs and information by producing accounting numbers that can be used in contracts among different parties. Other benefits of conservative accounting are as follows:

- Conservatism in accounting reduces the probability of excess payments to managers at the expense of shareholders, or if the case may be excess distributions to shareholders at the expense of debtholders.
- Conservatism in accounting also leads to deferment of earnings and generation of lower cumulative earnings and lower net assets which are more likely to result in reduce expected litigation costs for the firm than overstatement of net assets.
- Conservatism in accounting results in better monitoring of management
- Conservatism in accounting reduces the likelihood of litigation costs
- Conservatism in accounting leads to the production of more timely accounting information and acknowledgement of bad news for the scrutiny of directors along with sufficient reasons for investigating the reasons for investigating the bad news.

[7] Watts, 2003a.
[8] Watts, 2003b.

4. Case Study-Ericsson and conservatism in strong governance firms vs. weak governance firms

In order to measure the level of accounting conservatism in corporate governance we have included in our assignment a case study on Ericsson, Swedish Telecommunications Company.

- [9]Ericsson is the largest supplier of mobile systems in the world and supports all major standards for wireless communication.
- Ericsson provides total solutions - from systems and applications to services and core technology for mobile handsets.
- Ericsson has been active worldwide since 1876 and is today present in more than 140 countries with headquarters located in Stockholm, Sweden.

We adopt Basu's (1997) measure of conservatism measured according to the following econometrics function:

$$Xt= \beta_0 + \beta_1 D_t + \beta_2 R_t + \beta_3 D_t R_t + \mu_t$$

where Xt is earnings per share before extraordinary items and discontinued operations deflated by share price at the beginning of the period. Rt is the stock rate of return of the firm, measured compounding twelve monthly [10]CRSP ending the last day of fiscal year t.4 Dt is a dummy variable that equals 1 in the case of bad news (negative or zero stock rate of return) and 0 in the case of good news (positive stock rate of return). The coefficient β3 measures the level of asymmetric timeliness—the level of conservatism—and it is expected to be positive and significant.

The results of the regression have been summarized in **Table 1**.

[9] www.ericsson.com
[10] The Centre for Research in Security Prices-http://gsbwww.uchicago.edu/research/crsp/ stock returns

Constant	β_0 **tstat**	0.11 0.20
D	β_1 **tstat**	0.00 0.23
Return	β_2 **tstat**	0.12 0.34
D*Return	β_3 **tstat**	0.04 2.75
Adj R^2		0.20

The value of β_3 indicates that there is a positive significant level of conservatism in accounting practices followed by Ericsson.

Incorporating the level of governance within the firm we apply the following: a composite governance variable (Totgov) that incorporates the level of antitakeover protection (external governance) and several characteristics of the board's structure (internal governance), based on a similar measure by Bertrand and Mullainathan (2001). Following Bertrand and Mullainathan (2001), we define the composite governance variable (Totgov) by taking the unweighted average of the standardized variables based on unit weights following the recommendations of Grice and Harris (1998), The standardization is performed to take into account the different scales of the variables that make up the composite measure. Higher values of Totgov are expected to be associated with governance structures with higher antitakeover protection and high CEO influence in board decisions.

$$Xt= \beta_0 + \beta_1 D_t + \beta_2 R_t + \beta_3 D_t R_t + \beta_4 D_t R_t Totgov_t + \mu_t$$

The results of the regression have been summarized in **Table 2**.

		Dep variable X		
		MTB tercile		
		Low	**Medium**	**High**
Constant	β_0 tstat	0.11 0.20	0.05 0.16	0.08 0.34
D	β_1 tstat	0.00 0.23	0.03 -0.34	0.00 -0.16
Return	β_2 tstat	0.12 0.34	0.06 3.00	0.07 2.67
D*Return	β_3 tstat	0.04 2.75	0.09 2.50	0.13 4.56
D*Return*Totgov	β_4 tstat	0.02 3.46	0.03 1.24	0.02 3.56
Adj R^2		0.20	0.13	0.12

When the dependent variable is earnings (X), the asymmetric timeliness of earnings coefficient β3 provides an estimate of the level of conservatism. We observe that strong governance firms are more conservative than weak governance firms (0.13 versus 0.04).

5. Conclusions

Theory indicates that accounting conservatism is important to establish an efficient corporate governance system. The case study of Ericsson supports the theoretical evidence, albeit the sample is small. An important aspect is that new accounting standards have recently been introduced and we do not know what effect they will have. According to the European standard-setters IASB, the unquestionable purpose of accounting is to give fair presentation of information in order to help users to make economic decisions under several well-established accounting conventions such as going concern, matching, and prudence.

Matching

Clearly making major assumptions about the future, the matching convention builds on the going concern convention that allow us to forward assets into future periods on that they will be used profitably later. In order to devise these recognition rules and heuristics the IASB requires that similar items, some of which are positive and others negative, must not be treated symmetrically.

Prudence

In the case of the IASB, prudence is not supposed to be overruling. Instead it is a degree of completeness where omissions would cause the financial statements to be misleading. If an investor tries to be conservative, the investor will almost certainly understate assets and pricing, such as valuing land or real estate based on original costs rather than present values.

Given what IASB states about prudence (conservative accounting) it seems as there will still be some room for conservative accounting with the new rules, but we also believe that it depends on the accounting rule in question. Since the governments have the legislative power state participation used to be an important aspect of accounting rules, but the governments are becoming less important since independent organs decide upon the accounting rules. Despite this fact, being an active investor in the Swedish economy still means the government is in position to demand information. In Sweden, banks' equity was transferred to funds organized as closed-end investment funds due to beliefs that are clearly reflected in tax policies that favour debt and, in particular, discriminate equity. Two of these funds, Investor and Industrivärden, have become the strategic investments of the two most powerful Swedish ownership structures, the Wallenberg and Handelsbanken, who control Sweden's largest listed companies.

One benefit of acceleration of recognition of bad news is reduction in the likelihood of unforeseen costs. Matching and prudence can provide the board of directors with early-warning signals to investigate the reasons for the bad news. Conservatism can also yield

unrecorded goodwill when understatements are made.[11] During transition periods conservatism should occur until results are explained, so the strong governance can result in better monitoring of committees and produce more accurate information. More conservative borrowers also benefit lenders.[12] Conservatism results in all these beneficial outcomes.

We conclude that there are several reasons to use accounting conservatism in corporate governance and that current empirical evidence indicates that conservatism has increased in the last decades, but we do not know if this trend will continue in Europe with the new accounting rules.

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We expect and hypothesize that strong governance structures will tend to favour accounting conservatism more than weak governance structures. However, excessive dependencies on old structures show poor growth that has been since the oil crisis in the Western world.

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