Conservatism in Accounting

By

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A thesis submitted in partial fulfillment
of the requirements of the University Honors Program
University of South Florida St. Petersburg

April 15, 2015

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University Honors Program
University of South Florida St. Petersburg

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Abstract

The accounting principle of conservatism has its roots with bankers and debt financing. Bankers have urged businesses to underestimate earnings and overestimate expenses in order for the investors to make safer decisions in the future. Conservatism was relatively practical during the rudimentary beginnings of business. However, due to changes in corporate finance and new users of financial statements, conservatism has no place in financial accounting. Undoubtedly judgments and estimates must be made, but conservatism is no longer an accounting principle and the most accurate figure possible should be used with no bias in either direction.

Conservatism in Accounting

"The assumption is that human economies are built on reciprocal exchanges and accounting concepts such as double entry, matching and conservatism are believed to be in harmony with the way the brain functions. An example is the concept of conservatism where gains are not anticipated but losses are."[1] This quote is written in an introductory financial management textbook specifically authored toward non-financial managers. It summarizes quite well the prevailing reason how conservatism began in the accounting context and why it continues to exist. When running an organization, it is important to maintain an adequate supply of resources. In order to effectively plan for the future, one must be able to look at the accounting records of the past and forecast what might happen later on.

Clive Marsh, the author of the above quote, is one of many who claim that there is a logical, or perhaps even psychological, reason that accountants and lenders prefer to be conservative in their figures. However, the main reason that conservatism has become so pervasive in the field of accounting is the origin of the profession itself. Conservatism is an inherent bias in financial reporting and in today's environment it is no longer a necessary or correct principle due to changes in corporate finance and users of financial statements.

In order to understand the significance of why one should care about conservatism in the first place, it is crucial to understand and clarify the origins of the accounting profession and concepts. Bookkeeping and accounting are the means by which businesses maintain records of business transactions to measure past performance and ensure the accurate reporting of assets and liabilities. Accounting has existed in one form or another since the very first farmer walked

[1] Marsh, Clive. *Financial Management for Non-Financial Managers*, Kogen Page. Philadelphia 2012 p482

outside one morning, counted his oxen, and compared that number to the number of oxen he counted the night before. There are 7000 year old Babylonian and Assyrian accounting records that have survived to the present; these records are the first written documents that show the use of record keeping and the concept of credit. Ancient Egypt, China, Rome, and Greece all maintained very effective systems of accounting that led to effective management of private trade and government record-keeping. These accounting methods were very rudimentary, but very effective for maintaining records of such things as interest returns and receivables.[2] The struggle ancient accountants had in maintaining accurate accounting records seems to have been inhibited not by a primitive thinking of mathematics or accounting concepts, but a lack of efficient equipment such as paper and writing instruments. Michael Chatfield, Professor of Accounting at California State University, emphasizes that point with his claim that the accounting methods used by the American colonists thousands of years later were still "more backward than that of ancient Egypt".[3]

Moving beyond accounting in antiquity, the practice of modern accounting is agreed by scholars to be around 500 years old.[4] It began in 1494 when the Franciscan monk Luca Paciolo, the "father of modern accounting", published his text on mathematics and accounting titled *The Collected Knowledge of Arithmetic, Geometry, Proportions and Proportionality*.[5] Even though we have proof that many of the concepts he wrote about had existed over 200 years earlier, what makes the post-Paciolo period so significant are the changes to concepts and the increasing accuracy of accounting that followed. Before Paciolo, the methods and teachings he wrote about

[2] Littleton, A. C. *Accounting Evolution to 1900*. University of Alabama: U of Alabama, 1981. Print. p.32
[3] Chatfield, Michael, CPA. *A History of Accounting Thought*. Huntington, NY: Robert E. Krieger, 1977. Print. p.7
[4] Hatfield, Henry Rand. *Modern Accounting*. New York: Arno, 1976. Print. p. 1
[5] Chatfield, p.46

had seen limited use but even then were “used badly.”[6] His writing was primitive compared to modern accounting theory, but it laid the foundation for the double entry method of accounting. In doing that, he established the following equation:

Assets + Liabilities = Owners Equity.[7]

Although transactions have increased in complexity and gotten more difficult to measure, this simple formula still forms the basis for all accounting transactions today. Understanding its significance is important to grasp the flaws in the conservatism concept which will be discussed later.

The double entry accounting method was perhaps the most crucial step in the development of accounting concepts.[8] Dating to the early 14th century and the Massari accounts of Genoa,[9] it moved accounting away from counting physical things, such as animals, and into the realm of finance and money. It should come as no surprise that the development of the double entry method came about during the Renaissance and Venetian-Byzantine trade boom when vast amounts of capital were being created and goods traded globally. Prior to this expansion of trade, transactions were recorded much differently than in modern accounting. Whereas today there is a single Sales account and a single Cost of Goods Sold account, transactions prior to this time were conducted and recorded individually. An item would be recorded for the amount of money it cost the seller with the profit from the sale of that specific item being recorded with it. This method for recording transactions was very time consuming, but it was very thorough as well. The need for independent accountants and elaborate transaction

[6] Richard Brown, ed., *A History of Accounting and Accountants* (Edinburgh: Jack, 1905), 94
[7] Hatfield, p. 1
[8] Ibid. p.41
[9] Chatfield, p.36

methods to help verify balances was unnecessary due to the small scale of trade and intimate knowledge the business owner would have had during that time.

"The majority of merchants were probably so intimately concerned with the details of their own business affairs that they did not need elaborate accounting calculations to inform them of the size of their fortunes or to acquaint them of the results of their enterprise. It is likely, indeed, that the merchant's knowledge of his affairs would have been so sound that he would have been able to detect errors in the calculations of his bookkeeper."[10]

Another hypothesis for the lack of double entry bookkeeping being developed any earlier was the lack of an effective numeral system. The Romans, Greeks, Egyptians, and Chinese did not use the Arabic numeral system or any other numeral system that could be efficiently added together neatly in columns or rows[11]. Because separate numbers couldn't be arranged in any practical way that would allow them to be added and effectively compared, there was no incentive to create separate columns of debits and credits which are crucial to the double entry method. Before the advent of currencies and complex business transactions there was very little need for double entry accounting, but as commerce increased and businesses required more effective record-keeping the advantages of double entry accounting became apparent.[12]

Conservatism can be defined as "anticipate no profits and provide for all probable losses."[13] It is a cautious approach to uncertainty that is reflected in the financial statements and accounting procedures. Some of the first documented cases of conservatism by accountants

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[10] Yamey, Basil S. *Essays on the History of Accounting*. New York: Arno Press, 1978. Print. p.111
[11] Ibid. p.41
[12] Littleton, Ananias Charles, and Basil S. Yamey. Studies in the History of Accounting: Edited on Behalf of the Association of University Teachers of Accounting and the American Accounting Association. Homewood, IL: Irwin, 1956. Print. p. 20
[13] Bliss, J. H. (1924). *Management through accounts*. New York: The Ronald Press Co.

occurred around the same time Paciolo developed the double entry method. While conservatism may have been used for millennia beforehand, these cases from the medieval time period involved deliberate and documented understatement of manorial income and expenses. The manor's self-sufficiency placed limits on what it could produce and sell. In order to prevent over-extending its resources, conservative figures were used. Conservatism was used then as it is used today, as a form of self-preservation for the business entity.[14] Medieval stewardship may have also been a contributing factor. The steward of the lord's property, out of concern for his employment and lord's welfare, was most likely conservative in recording financial records as a form of self-protection. Walter of Henley, in the early fourteenth century, wrote that manorial accounts should be "faithful and prudent."[15] That stewards of property for rich, powerful lords would be conservative in their figures should come as no surprise. Running out of materials and stockpiles unexpectedly could lead to the steward being fired, or even executed.

It is no coincidence that Paciolo's accounting work was published during the time of a global explosion in trade and commerce; similarly, conservatism's roots being intertwined with the origins of modern accounting no doubt contributed to the proliferation of the concept. Just as the increasing amount of business during the Renaissance created a need for new accounting procedures, the Industrial Revolution produced a revived need for more accurate record keeping to keep up with the vast amounts of information and wealth being exchanged. A.C. Littleton explains it as follows:

> "It is not without significance that bookkeeping appeared at the end of the fifteenth century, nor that its birthplace was the Italian republics. We all know of the marvelous awakening of that period, and particularly of the sudden expansion of commerce….But bookkeeping dozed for

[14] Chatfield, p. 28-29
[15] Basu, Sudipta. "Conservatism Research: Historical Development and Future Prospects." *China Journal of Accounting Research* 2.1 (2009): 1-20. Web. 15 Feb. 2015. p.1

> several centuries, and it was not until about four hundred years after Paciolo's book that a startling awakening took place…Why this new prominence in a subject taught before 1500? The answer is so obvious that explanation seems impertinent. The end of the nineteenth century, more so than the end of the fifteenth, was marked by an extraordinary expansion of business."16

With this increasing need for accurate record keeping came an increase in the use of external auditors. External auditors are hired by companies to provide assurance to their stakeholders that the financial statements are free from material misstatement. While internal auditors perform many similar functions to external auditors, auditors independent from the organization produce audit opinions that are viewed as being more fairly represented due to the separation that exists between company management and auditors. The modern need for external auditors, financial statements, and unbiased, accurate record-keeping arose in England shortly before the Industrial Revolution. Along with the immense wealth which tea, slavery, sugar, steamships, railroads, and the textile industry brought England, there arose a great need for impartial public accountants to validate financial statements of companies dealing in these commodities.[17] While eventually laws would be written requiring public companies to be audited, many companies in the 19th century instituted audit requirements not due to any legal reasons but because it was a demand of shareholders. Gary F. Spraakman explains the origins of the Hudson's Bay Company's external audit program as,

> "The regulatory requirement for external audits in many industries in the last 40 years of the 19th century was a major event in the development of the public accounting profession. Similarly, the 1866 introduction of external auditors was a significant accounting event not just for the HBC but for other public companies as the driving force was not regulation. It was the shareholders who saw the benefits and who requested that the financial statements be audited to make them more useful. In that way, it was an early example of shareholders and managers with

[16] Littleton, *Accounting Evolution to 1900*, p. 9
[17] Littleton and Yamey, p. 357

> external auditors working together in pursuit of standardized and informative audited financial statements. The purpose was to provide the shareholders with a better understanding of the company's ability to pay dividends and to expand in North America."[18]

Banks needed a way to verify a company was making as much profit, had as many assets, and was successful as it said it was in order to lend money. The amount of money a bank would loan, and at what interest rate, depended not only upon what the company's financial situation looked like but how accurate the numbers were. External audits on behalf of shareholders led to lenders being increasingly dependent upon verified financial statements before making investment decisions. As the employment of external auditors became commonplace and lenders began to refuse service unless financial statements had been independently verified, regulations were written requiring public companies to be audited.[19]

The 19th century's boom in industry and business allowed accounting to blossom simultaneously. During this time, new methods and systems for cost and financial accounting were developed for use by the titans of British industry. The use of these accounting methods coupled with a change in the way businesses were run during this period would quickly change the nature of the British economy; rapid industrialization and the widespread availability of fairly represented financial statements were significant.[20]

Incorporation without royal charter was first made possible in England by the Joint Stock Companies Act of 1844. The 1844 Act was created in order to give those not belonging to the aristocracy the ability to incorporate a business. This capability was sought by both individual

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[18] Spraakman, Gary F. "The First External Auditors of the Hudson's Bay Company, 1866." Accounting Historians Journal 38.1 (2011): 77. Web.
[19] Ibid, p.75
[20] Miranti, Paul J. Accountancy Comes of Age: The Development of an American Profession, 1886-1940. Chapel Hill: U of North Carolina, 1990. Print. p. 30

businessmen who wanted to incorporate, and the Crown which had overseen complex legal suits in companies with thousands of owners. Because incorporation was not possible without royal charter and limited liability did not exist, any time a company was named as a defendant in a lawsuit or bankruptcy proceeding, each owner had to be individually named in the lawsuit. With some companies having thousands of owners, this was extremely time consuming and made effective liquidation of a bankrupt company's assets extremely onerous.[21] The act also called for accountants to maintain books of account and required them to be balanced. It required balance sheets to be presented to shareholders and required external auditors to be given unrestricted access to the information necessary to perform their audits. [22] This was remarkably modern given that similar accounting laws in the United States were as recent as 1934, but it was also primitive. The spirit of the law was to regulate minimum disclosure of companies and banks in order to achieve a comprehensive financial picture. However, many of these requirements were reversed for public companies by the Joint Stock Companies Act of 1856 and "compulsory accounting requirements and compulsory audit for registered companies were abandoned."[23] In the face of this deregulation of public companies, banks were still required to have annual audits and produce financial statements.

This lack of independent auditors and accounting requirements in 19th century British industry is one of the most significant reasons for the rise of the conservatism principle in modern accounting. It would not be until 1900, after a series of disastrous bankruptcies, that all regulated companies would again be required to provide audited financial statements.[24] It is in

[21] Littleton and Yamey, p.357
[22] Ibid. p. 356
[23] Ibid. p. 361
[24] Miranti, p. 30

this frame of reference, the deregulation of business and overregulation of banks during a period of tremendous growth, that we can begin to examine the origins of conservatism.

Similar to the situation of the medieval steward concerned for his wellbeing, even into the 20th century accounting conservatism was rooted partly in fear. Replacing the medieval lord was the court system, which consistently ruled in favor of plaintiffs suing accountants who were not prudent (conservative) enough in their estimations. In *Newton v. Birmingham Small Arms Co Ltd* (1906), the English court held "Assets are often, by reason of prudence, estimated and stated to be estimated, at less than their probable real value. The purpose of the balance-sheet is primarily to shew that the financial position of the company is at least as good as there stated, not to shew that it is not or may not be better."[25]

Coincident with the deregulation of business in the mid-1850s, a vast series of bankruptcies and lost investment funds occurred. A look at statistics of British start-up companies provides an excellent tool with which to understand the harshness of British industry at the time.

> 25.6 per cent of the companies formed 1856-65, 30.3 per cent of the companies formed 1866-74 and 33.4 per cent of the companies formed 1875-83 ended in insolvency. For the whole period 1856-83, the average is just over thirty per cent. Of the companies formed 1856-65 half of the liquidations took place within the first six years of existence; of the 1866-74 liquidations half took place within the first five years of existence; of the 1875-83 liquidations half took place within the first four years of existence.[26]

Robert Parker, professor of accounting at the University of Exeter, asks if the initial conservatism was natural or a product of the business environment. This question is significant;

[25] Basu, 2
[26] Parker, Robert H. *Papers on Accounting History*. New York: Garland, 1984. Print. p.23

the opening paragraph of this paper refers to Marsh Clive's statement that conservatism is in harmony with the way the brain functions. However, it is clear that the origins of the modern accounting profession took place in an environment where conservatism was not only rooted in its history and encouraged, but necessary for survival.[27] While accountants did very well during the boom years of British trade, when a massive downturn of the economy in the mid-19th century occurred, they were blamed as the reason that no one saw the rash of bankruptcies coming. With such alarming numbers of bankruptcies, any tendency to overestimate profits would be met with harsh scrutiny by the government, banks, and shareholders. Anthony Sampson describes this origin as having a history filled with a "vivid sense of disaster"[28] which no doubt contributed to conservatism in the issuance of financial statements.

The British belief that conservatism was necessary quickly made its way to America. "Following the American Civil War, the United States quickly emerged as a rapidly growing industrial power. Throughout the 1870s, and especially the 1880s, British capitalists invested heavily in the robust American economy. To oversee their financial interest, British investors increasingly engaged their accounting firms to make periodic visits to the United States."[29]

British investment in America was nothing new; after all, the United States had formerly been one of Britain's chief sources of timber, tobacco, and cotton. However, it was not until the Industrial Revolution was in full swing that massive amounts of foreign capital begin to pour in from the United Kingdom.

> "Though accountancy as a business function dated back to antiquity, the organization of a substantial service industry to provide counsel about these

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[27] Parker, p.24
[28] A. Sampson, *Anatomy of Britain Today*, London, Hodder & Stoughton, 1965 p.525
[29] Allen, David Grayson, and Kathleen McDermott. *Accounting for Success: A History of Price Waterhouse in America, 1890-1990*. Boston: Harvard Business School, 1993. Print. p.3

> matters was one of the many new outgrowths of the nation's industrialization. Initially organized in Britain more than a generation earlier, the profession of public accountancy first flourished in America during the 1880s as a result of the growing need among businessmen and investors for objective economic data."[30]

When British shareholders started encouraging their operations overseas be audited and examined by British accounting firms, firms such as Price, Waterhouse & Co. (PW) began to do business in the United States.[31] PW's first visits to the United States were as early as 1873, but "despite his strong disinclination to create branch offices, Waterhouse acknowledged by 1887 that 'the business was growing and an American connection was springing up which made it necessary for us to send Mr. Sneath, or a principal clerk, frequently across the Atlantic.'" [32] Even still, it would not be until 1901 that PW established a self-sustaining office in America.[33] While accounting and accountants had existed long before British professional firms influenced the American accounting profession, their influence was very significant and lasting. The practices and concepts that were brought with these British accountants to the New World would proliferate quickly among their American counterparts. British accounting has made enormous impacts on the American profession and to this day two of the Big Four accounting firms remain headquartered in London despite earning a sizeable portion of their revenues in the United States.[34]

Why is adding or removing an accounting concept necessary at all? Given the trust that stakeholders place in fairly represented financial statements, the importance of ethical conduct

[30] Miranti, p. 25
[31] Ibid. p.12
[32] Ibid.
[33] Ibid. p.27
[34] "PwC London HQ Achieves Highest Ever Environmental Rating for a UK Office. - Press Room." *PWC Headquarters*. PWC, n.d. Web. 20 Nov. 2014. "EY Facts and Figures." *EY Facts and Figures*. Ernst and Young, LLP, n.d. Web. 20 Nov. 2014.

cannot be understated. Although there have been claims of negligent accountants from antiquity to Enron, the profession as a whole has enjoyed a very positive reputation among businesses, governments, and the population for being trustworthy. Stakeholders have relied on the word of accountants for investment decisions for centuries. This positive perception is based on, and influenced by, the adherence to codes of conduct set forth by the profession itself. For generations before Sarbanes-Oxley[35], the profession was self-regulated by professional organizations of accountants.

> The success of the early chartered accountants also stemmed, in part, from their ability to build confidence among other important social groups. Accountants had to convince them that their new concept of professionalism was a valid substitute for older sources of authority , which were breaking down because of the changes brought by industrialization…The wealthy classes in British society needed new technical experts to certify the truthfulness of the information that influenced key investment decisions; they needed experts who possessed the same degree of personal integrity and honor expected from the older, local sources of authority.[36]

The significance of professionalism and integrity among accountants can be found in the tendency for professional organizations to be formed worldwide as the profession developed. The oldest society of professional accountants, the *Collegio dei Rexonati*, was founded in Venice in 1581, less than a hundred years after Paciolo's *Summa*. This society required a 6 year apprenticeship, and a two-thirds vote of approval for new members to be admitted. "By 1669 the college had become so powerful that no Venetian could do accounting work, either in connection with public administration or the law, unless he was a member."[37]

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[35] Passed by Congress in 2002, the Sarbanes-Oxley Act was written to protect users of financial statements from fraud and accounting misstatements.
[36] Miranti, p. 31
[37] Brown, p. 177

Centuries later in Britain, this process continued in an almost identical fashion. The profession ensured that only "reliable" men would become accountants (and they were all men). "Through professional associates, chartered accountants built confidence that their members were both technically competent and morally fit. To this end, candidates for admission were required to serve a five year apprenticeship under the direct guidance of a chartered accountant and successfully complete a rigorous four-part examination administered by the Institute of Chartered Accountants."[38]

With the activity and influence of British accountants in America, it is not unreasonable to presume these organizations would make their way to the United States. While more fluid, dynamic, and politically involved than their brother organizations across the pond, American accounting organizations still promoted this concept of self-governance and self-regulation.[39] The perception stakeholders have of accountants as unbiased professionals who adhere to rules, ethics, and morals makes having an illegitimate accounting principle harmful. Accountants are bound to an ethical code of conduct both voluntarily and legally which stems from the idea that accountants are the gatekeepers for highly reliable financial information. The public places an enormous amount of trust in the opinions issued by external auditors, and having the accounting principle of conservatism that introduces bias and errors into financial statements conflicts with fairly presented financial statements on which users depend.

One example of this adherence to a principle in contrast to ethical values is the lower of cost or market concept (LCM). This concept requires recording assets at either their cost to the company or the current market price – whichever is lower. This is done in order to ensure the

[38] Miranti, p. 31
[39] Ibid. p. 6

assets (and therefore the company) are not overvalued. However, even in the early years of lower of cost or market, people understood the need to account for their inventory accurately, rather than merely guessing on the safe side. “Alexander Malcom (1731) preferred cost to using ‘the current Rates’ since ‘it seems more reasonable to value goods as they cost you; for otherwise you bring in Gain or loss into your accounts, which has not yet actually happened and may, perhaps not happen.”[40]

Clearly, conservatism in America and Britain should have never existed. The idea that accounting records should show the most accurate figures was not anything new. A.C. Littleton explains, “Whereas value is an estimate of what price ought to be, price itself is an established fact…When accounting is loosed from this anchor of fact it is afloat upon a sea of psychological estimates which, however important they may be to business management, are beyond the power of accounting, as such, to express.”[41]

The need for objective economic data outweighed the need of the company to estimate conservatively, yet there are numerous examples, such as LCM, of accounting concepts and procedures that were based on conservativism that led to companies being unable to obtain financing and to opportunities for fraudulent reporting. Despite conservatism largely being a result of heavy debt financing and banking requirements, conservative estimate requirements may have hurt banks as well by disallowing companies that were otherwise capable of repaying the loans from obtaining financing.

Despite attempts by Parliament to regulate business financial reporting, conservatism was still entrenched in business. The British practice of conservatism became even more standardized

[40] Parker, Robert H. *Papers on Accounting History*. New York: Garland, 1984. Print. p.20
[41] A.C. Littleton, *Value and Price Accounting*, Accounting Review, Vol 4 1929 pp 149, 150

in America because bankers were the most powerful users of financial statements. Businesses were extremely keen on issuing conservative financial statements in order to obtain good financing rates as well as using conservative reserves for income smoothing. It was not unknown to those in charge of writing accounting regulations that conservatism made possible the earnings manipulations that permeated businesses at the time, but the importance of conservativism for debt financing overruled these accounting discrepancies. "The possibility of deliberate under-statement of income did not receive attention in the legislation, though the fact that profits of earlier years – possibly undisclosed at the time they were made – might be used to deceive the investing public later when profits were lacking did not, as we have seen, escape all notice."[42]

The allowance for doubtful accounts figure is an estimate that was instrumental in income smoothing schemes. This estimate is decided by management and creates a fixed reserve that is used to offset uncollectible receivables as they occur throughout the fiscal year. This reserve provides management an excellent backdoor way to meet analysts' earnings per share targets. By conservatively estimating future bad debts management can release these reserves into earnings to meet targets. Other methods such as accelerated depreciation methods, expensing advertising costs are also unconditional.[43] They are conservative in nature and applied consistently regardless of timing.

These methods all provide opportunities to deliberately mislead financial statement users, and contribute to an undervalued organization on the books. Expensing certain costs eliminates them from the balance sheet and makes them appear to no longer benefit the organization. "For example, R&D expenditures could provide future benefits to the firm in the form of future sales.

[42] Littleton and Yamey, p.356
[43] Ruch, George W., and Gary Taylor. "Accounting Conservatism: A Review of the Literature." *Journal of Accounting Literature* 34 (2015): 17-38. Print. p.21

However, the immediate expensing of R&D under conservative accounting ignores these future benefits by prohibiting accounting from capitalizing the expenditures."[44] Similarly, book depreciation methods that write down assets more quickly than their actual depreciation (meaning, the physical deterioration of the equipment) skew the perception investors have of the company's fixed assets.

Yet another example of earnings management made possible by conservatism is the manipulation of profit to reduce income tax expense. In the early 20th century, when countries began taxing corporations via income tax, corporations realized that by exercising unconditional conservatism they could limit their tax expense. "The introduction of corporate income taxes in the early 20th century generated a demand for unconditionally conservative accounting methods to minimize taxable income, and these new methods influenced financial reporting. As Ball and Shivakumar (2005) point out, the muddling together of conditional and unconditional conservatism probably caused more confusion about the desirability of conservatism."[45]

As mentioned by Sudipta Basu above, conditional conservatism is applied differently than unconditional conservatism. An example of conditional conservatism is the asymmetry between gain and loss contingencies. Firms are required to recognize losses as soon as they are probable and the amount can be reasonably estimated, however the standard for gain contingencies borders on absurdity with respect to the requirements that must be met to even disclose them in the financial statements. Generally speaking, a gain must be realized before it can be reported whereas a loss is reported as soon as the amount and nature of the loss are known to the company. This creates a discrepancy in the financial statements; they may have recorded

[44] Ibid. p. 25
[45] Basu, Sudipta. "Conservatism Research: Historical Development and Future Prospects." *China Journal of Accounting Research* 2.1 (2009): 1-20. Web. 15 Feb. 2015. p.3

or disclosed losses, which need to satisfy a much lower standard, but miss gains that will be realized that have not yet met the standard for disclosure.

While some unscrupulous businesses undoubtedly enjoyed the ability to manage earnings by using conservatism, the confusion that emanated from “conditional” and “unconditional” conservatism has served to hasten the demise of conservatism among ethical and academic accountants. American bankers, the most powerful users of financial statements, were protected by conservatism. This created a system where conservatism was encouraged in spite of the knowledge that it was inappropriate. Accountants were sued for not being conservative enough, and businesses faced high interest rates or outright denial of financing if their financial statements did not abide by bank standards of conservatism. Indeed, even today accountants risk being sued for failing to find financial misstatements during audit. “Today, the emphasis on assistance to management has been overshadowed by the specter of liability to third parties. Indeed, some CPAs would assert the pendulum has swung too far toward an adversarial relationship between independent auditors and management…”[46] This fear may be responsible for knowledgeable accountants to continue using conservative estimates.

To understand the influence banking and debt financing had on conservatism’s origins and pervasiveness in accounting, it is necessary to understand the origins of corporate finance. Going back to antiquity, business ventures were financed with debt. An individual, government, or bank financed a company on the basis that they were to be paid back over a period of time. This form of finance requires a degree of trust that the company or person to whom the money is

[46] Olson, Wallace E. The Accounting Profession: Years of Trial, 1969-1980. New York: American Institute of Certified Public Accountants, 1982. Print. p. 15

loaned will be able to pay the lender back. This form of finance was the most significant reason that financial statements and auditors became necessary.

Lenders wanted to be able to see the company's performance and wanted some sort of independent verification that the company was doing well. This method of raising capital also contributed to the conservatism principle being applied in the accounting records. Lenders wanted to know that the financial statement figures they were looking at were not overstated in any way. In *The History of Corporate Finance*, Jonathan Baron Baskin and Paul Miranti Jr. explain the dependence upon debt as a source of corporate capital, and relatively infrequent use of common stock before the early 20th century.

"Besides providing the primary source of seed capital, debt was also the means by which most additional funds were solicited from the public. Nominal funded debt in 1913, for example, amounted to $11.2 billion, compared with $7.2 billion of par value common stock. But these figures actually understate the heavy reliance on debt."[47] This reliance on debt continued through the 1960s when Miranti claims that "managements of center firms were generally loathe to finance their activities by issuing equity."[48] This partly stemmed from issues pertaining to diluting ownership of companies among current owners. Managers of corporations were strongly disinterested in any changes that may upset their ability to manage effectively.

Common stock only became a major source of corporate finance relatively recently.[49] While the practice of investors owning stock in companies had existed for hundreds of years, it was not until the late 20th century that public shares of corporations began to raise significant

[47] Baskin, Jonathan Barron, and Paul J. Miranti, Jr. *A History of Corporate Finance*. Cambridge: Cambridge UP, 1997. Print. p. 150
[48] Ibid, p. 244
[49] Ibid, p. 15

capital. "Total annual share turnover rose from 159 million in 1900 to 1.1 billion at the height of the 1929 boom; the value of preferred and common stocks underwritten amounted to $405 million in 1910 and increased to $9.5 billion in 1929…"[50] This growth in equity was quickly stunted by the Great Depression, and only began increasing again in the 1950s and 1960s. Once equity financing did become popular again, conservatism became less and less accepted by financial statement users.

Debt financing strongly affects the financial statements which is why conservatism was so deeply entrenched in the fabric of financial reporting. In *Is Financial Reporting Shaped by Equity Markets or by Debt Markets?,* Ray Ball, Ashok Robin, and Gil Sadka analyze 78,949 annual earnings reports from 22 countries regarding the effect debt has on financial reporting. They conclude, "These results are inconsistent with the basic premise of the influential "value relevance" school of accounting thought, in which financial reporting exists primarily to inform equity markets. This viewpoint is implicit in studies that use the R2 measure of association between market prices and financial statement variables as a financial reporting criterion. In contrast, the results are consistent with the "costly contracting" school of accounting thought, and in particular with the hypothesis that the debt market exerts a substantial impact on accounting practice."[51]

As implied earlier, conservative accounting practices have some debt-related benefits. Jieying Zhang's research indicates "...that lenders lower the interest rates they charge to conservative borrowers."[52] For companies which are not public where the risk of misinforming

[50] Ibid, p. 168
[51] Is Financial Reporting shaped by debt Ball Robin etc p.34
[52] Zhang, Jieying. "The Contracting Benefits of Accounting Conservatism." Journal of Accounting & Economics 45 (2008): 27-54. Science Direct. Web. 20 Mar. 2015. p.28

owners and users of financial statements is low (i.e. sole proprietorships) and for banks issuing loans to such companies the ability to have a "worst case" balance sheet and income statement may be seen by some to reap tangible benefits for both parties with minimal risk.

However, ideas such as these are still problematic. Private companies, even more so than public companies, must do their best to keep their books at the fairest value possible. This is necessary due to the possibility and ease with which privately owned companies may be sold. In such cases it is necessary for both the buyer and seller to obtain a true valuation of the company, but this true valuation is hampered by conservative accounting.

With worst case balance sheets the banks are receiving information that can point to a default at the earliest time possible. The point in time at which a loan covenant is violated is always going to be earlier if conservatism is used because the financial statements are always portraying the worst possible scenario. If bankers are quick to learn of impending default, they stand to recoup more of their loan amount. Zhang expands on this idea by explaining that conservative accounting practices reduce the amount of fees and costs associated with renegotiating loan covenants and recovering losses. This ends up being a net positive for lenders as the likelihood of default is lowered.

However, Zhang's research does not include a broad enough spectrum of conservatism. There was no research conducted of companies financially able to pay off debts which were not afforded opportunities for financing due to onerously conservative lending requirements and accounting practices. While Zhang's research shows that conservatism does indeed reduce interest rates for borrowers, it does not show other negative aspects inaccurate financial reporting has on the company's bottom line. Additionally, the type of research necessary to understand if banks are losing money by refusing financing to capable companies is impossible to perform

(due to lending requirements). The research also completely ignores the possibility that companies using conservatism in financial reporting may be doing so in a manner that is solely intended to meet specific requirements of lenders.

Zhang's claim that "the evidence in this paper has implications for standard setters when they consider the tradeoff between relevance (which favors fair value) and reliability (which is often associated with conservatism in practice)"[53] implies that lower interest rates and early detection of default risk are more important than fairly presented financial statements. This line of thinking is consistent with the scenario when debt financing and bankers were the primary influencers of accounting regulations, but with today's use of equity financing there are negative aspects to conservative reporting that outweigh any potential interest rate savings.

Just as debt financing's influence on accounting led to conservative accounting principles, banking's influence on the profession was equally strong. Until the 1970s, the lack of independent oversight over the accounting profession itself and the influence of bankers was significant. The Financial Accounting Standards Board (FASB) was created in response when it was appointed by the SEC in 1973 to replace the Accounting Principles Board. Generally speaking, FASB is now responsible for writing the Statements of Accounting Concepts which form the Generally Accepted Accounting Principles (GAAP) that regulate the procedures used in the accounting profession. The board has its roots as a subsidiary of the Financial Accounting Foundation (FAF) in the 1950s when, after World War II, the increasingly complex modernization and global integration of business began to require accounting procedures that were globally compatible.[54] As mentioned above, before this time the profession of accountancy

[53] Ibid. p28

[54] "Comparability in International Accounting Standards—A Brief History" Financial Accounting Standards Board FASB, September, n.d. Web. 5 March 2014.

was overseen by internal organizations such as the American Institute for Certified Public Accountants' Accounting Standards Board.

There was a belief, especially in the United States, that accounting was strictly "in-house" business. This was due in part to CPAs not wanting to create rules that may harm current clients, and an overall feeling that the profession should not be significantly regulated by outside entities. However, as the economies of different countries became more intertwined with the economy of the United States, a set of accounting principles that were generally accepted among all firms became necessary to allow for financial statement comparison. These changes began taking root when FASB was created.

"Unlike predecessor bodies, which had been exclusively controlled by the accounting profession, the FAF was supported by a host of statement user and issuer groups. In addition, the seven-member FASB included three voting members drawn from outside the public accounting profession. The FASB was served by a large professional staff, which did research in support of prospective practice standards; it also undertook an ambitious project to define the basic conceptual framework for financial accounting"[55] This change was significant as it created a formal body, which included professionals other than accountants and bankers, that could create and amend accounting rules by which all firms would abide. These changes were crucial to the accounting profession, as before this time there were no principles accepted on a large scale. This change included an acknowledgment that conservatism had no place in financial statements.

It is worth noting that the first volume of Accounting Principles, published the same year FASB became the focal point for standardization[56], mentions the following with regards to

[55] Miranti, p 228
[56] Ibid, p 229

conservatism: "A write-down of assets below amounts which are likely to be realized thereafter, though it may result in conservatism in the balance sheet at the readjustment date, may also result in overstatement of earnings or of earned surplus when the assets are subsequently realized. Therefore, in general, assets should be carried forward as of the date of readjustment at fair and not unduly conservative amounts…"[57]

As the influence of bankers began to wane, equity financing became more popular, and professional users of financial statements began to use financial statements as forward looking items, the degree of conservatism tolerated in financial statements decreased quickly and substantially. Less than a decade after the formation of FASB, in the Statement of Financial Accounting Concepts No. 2, FASB argued "There is a place for a convention such as conservatism—meaning prudence—in financial accounting and reporting, because business and economic activities are surrounded by uncertainty, but it needs to be applied with care."[58]

The 1996 GAAP[59] accepts an understanding that conservatism can lead to issues with financial statements in the future. "Conservatism in accounting may mislead users if it results in a deliberate understatement of net assets and net income. Such understatement is undertaken to minimize the risk of uncertainty to outside lenders. Unfortunately, such understatements often lead to overstatements in subsequent years, produce biased financial statements, and conflict with the characteristics of representational faithfulness, neutrality, and comparability."

By the 2000s FASB and others were beginning to analyze the effect conservative reporting had on equity users of the financial statements. Conservatism was driven by debt

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[57] *APB Accounting Principles, as of June 30, 1973*. Vol. 1. Chicago: Commerce Clearing House, 1973. Print. p.5581.04
[58] "Statement of Financial Accounting Concepts No.2" Financial Accounting Standards Board *FASB*, May 1980. Web. 5 March 2014.
[59] *GAAP* Interpretation of Generally Accepted Accounting Principles Delaney 1996 John Wiley Sons Inc. New York

investors who wanted a worst case scenario of the financial statements in order to ensure the company would remain a going concern. However, equity investors' interests lie in seeing that the company is profitable and, more recently, that the earnings per share figure is correct and as high as possible. In *Accounting Conservatism and the Cost of Equity Capital: UK Evidence,* Ann Chan, Stephen Lin, and Norman Strong acknowledge the following:

> Supporters of ''normative'' accounting theory widely believe that a firm with a higher degree of conservatism should be associated with higher quality earnings and therefore a lower cost of capital. Recent empirical evidence, however, does not fully support this view. Givoly and Hayn (2000, 2002) find that earnings conservatism increased in the USA during 1950-1998, contributing to a decline in reported profitability and an increase in earnings dispersion, and coinciding with declining earnings quality (Francis and Schipper, 1999; Barth et al., 1998; Collins et al., 1997). Penman and Zhang (2002) examine the effect of the interaction between conservatism and changes in investments on the quality of earnings. They find that when a company practices conservative accounting and its change in investments is temporary, current earnings are depressed or inflated and therefore are not a good indicator of future earnings. Thus, conservative accounting practice may not necessarily lead to good quality earnings, measured by earnings persistence and predictability.[60]

They put together compelling evidence showing that conservatism's effects, at least in conditional conservatism (what the authors refer to as earnings related or *ex post)*, are detrimental to equity users of the financial statements primarily due to the ease which management can manipulate earnings. It is relatively well documented that earnings related conservatism may result in investor scrutiny of financial statement figures as it allows for relative ease of accounting figure manipulation. While their research indicated that unconditional (balance sheet or *ex ante*) conservatism did contribute to higher quality financial information even when accounting for *ex post*, they recognize that other research has shown the opposite of

[60] Chan, Ann L.-C., Stephen W.j. Lin, and Norman Strong. "Accounting Conservatism and the Cost of Equity Capital: UK Evidence." *Managerial Finance* 35.4 (2009): 325-45. Web.

their conclusion in that “conservative accounting practice may not necessarily lead to good quality earnings, measured by earnings persistence and predictability.”[61] The difference of whether or not *ex post* conservatism simply outweighs *ex ant*e conservatism and results in these earnings inconsistencies is an opportunity for future research.

This discussion of equity financing and conservatism’s role in the future culminated in Accounting Concept Statement No. 8, published in 2010 which supersedes Accounting Concepts Statements No. 1 and No. 2. This concept further delegitimized conservatism by clarifying that financial reporting should be a faithful representation of the company’s true financial situation. While accounting procedures such as LCM, accelerated depreciation, and others still resulted in conservative reporting through their use, conservatism itself was discarded as a generally accepted accounting principle with this concept.

> Deliberately reflecting conservative estimates of assets, liabilities, income, or equity sometimes has been considered desirable to counteract the effects of some management estimates that have been perceived as excessively optimistic. However, even with the prohibitions against deliberate misstatement that appear in the existing frameworks, an admonition to be prudent is likely to lead to a bias. Understating assets or overstating liabilities in one period frequently leads to overstating financial performance in later periods—a result that cannot be described as prudent or neutral.[62]

By removing “prudence” as an aspect of reliability, the emphasis has shifted to verifiability. Prudent estimates[63] and accounting practices introduce bias into the financial statements which makes them inherently unfair.

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[61] Ibid.

[62] "Statement of Financial Accounting Concepts No.8" Financial Accounting Standards Board *FASB*, September 2010. Web. 20 March 2014.

[63] Reckless and overly optimistic estimates contribute to bias in the financial statements as well, but the emphasis is on accuracy and verifiability – absent bias in either conservative or optimistic directions.

Conservatism is no longer a principle of accounting. It developed as a result of the influence that banking and debt financing had on the accounting profession and industry as a whole. Early on, it became apparent that conservatism was being used as a tool for managers to store reserves and smooth earnings. Conservatism also introduces a measure of unpredictability into financial statements that prevents accurate record keeping. With conservative estimates being made, users have no idea how much conservatism is in a given financial statement, and whether that degree of conservatism is consistent with the user's own judgment. Now that users of financial statements other than bankers have influence in writing accounting regulations, we have seen the beginnings of a codified escape from conservative doctrine. Accountants are the scorekeepers and must provide an objective, faithful, and accurate assessment of a company's business using widely accepted principles. These assessments must allow investors and managers to make rational judgments without shaving points for either team. While this has been known for centuries, it's about time that it has been put into practice.

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