Is it Conservatism or Prudence?

Audrey M. Siahaan1, Danri Toni Siboro1, Iskandar Muda2 and Syafruddin Ginting2
1Student Postgraduate, Faculty Economic and Business, Universitas Sumatera Utara, Medan Indonesia
2Lecture Faculty Economic and Business, Universitas Sumatera Utara, Medan Indonesia

Keywords: Agency Theory, Positive Accounting, Conservatism, Prudence

Abstract: The purpose of financial statements is to provide information regarding the financial position, company performance and changes in financial position that are beneficial to a number of parties in decision making. Therefore, quality financial statement information is free from material misstatement. The impact of harmonizing financial accounting standards makes the wider spread of the concept of prudence more widespread. Researchers in this matter used literature studies to see how conservative concepts and prudence concepts in several countries. The concept of Prudence and the concept of conservatism are two contradictory things. From the results of the literature study, it was concluded that the concept of prudence would help financial reporting so as not to provide false optimism to users of information in the event of high uncertainty. Meanwhile, conservatives must be careful but if losses are recognized immediately. So, the concept of prudence is more transparent. However, the concept of prudence in developing countries has not been used differently from developed countries that have used prudence.

1 INTRODUCTION

The financial statements are prepared based on the Financial Accounting Standards that have been prepared by the body authorized to develop standards in this case in Indonesia, the Indonesian Accountants Association. The financial statements of a company describe the performance of the company's management in managing the company's resources entrusted to it. Information conveyed in financial statements is useful for internal parties and external parties in decision making. Therefore public companies are obliged to publish and present financial statements as a form of accountability for the management of resources.

The purpose of financial statements is to provide information regarding financial position, company performance and changes in financial position that benefit a large number of users in economic decision making. Therefore, quality financial statement information is free from engineering and presents actual information in accordance with the facts so as not to harm all parties who use it.

When preparing financial statements, companies are given the freedom to choose the accounting method used. Freedom in choosing a method can be used by companies to produce different financial reports with other companies in accordance with the wishes and needs of the company. Or in other words, companies have little freedom in choosing one of several alternatives offered in financial accounting standards that are considered to be in accordance with company conditions. For example, the company needs to reduce risks from unstable economic conditions, so to reduce the risk, companies usually take prudence in presenting financial statements. The concept of prudence is carried out by carefully recognizing and measuring assets, profits, debt, and costs. The concept of prudence is implied by recognizing the possible costs or losses that will occur, but not immediately recognizing future revenues or profits even though the likelihood is large. Prudence reporting is often referred to as accounting conservatism. Conservatism is an important principle in financial reporting that is intended so that the recognition and measurement of assets and profits are carried out with great care, this occurs because economic and business activities are surrounded by uncertainty. The implication of this conservative method is to report lower profits and assets or higher debt.
Accounting conservatism will increase bad news in a timely manner that is more relevant according to existing standards carefully so that it helps company managers and investors at the time of implementation. (Hsieh, Ma and Novoselov, 2018).

The views of some researchers that the conservatism of its popularity has lately diminished in the accounting cycle. The last few years are standard compilers and researchers are more likely to see about consistency, realization, going concern, and others.

There are researchers who support accounting conservatism because they can help corporate management to overcome agency problems. (Dhaliwal et al., 2014). Regulations regulated in financial accounting standards are intended that the standards made are expected to make the information in the financial statements must be neutral. Neutral is meant to be free of bias from anything that will influence decisions, for example, free from market friction, strong capital markets or full rationality or others.

To fulfill the qualitative characteristics of the IFRS conceptual framework, the concept of conservatism was abolished. The concept of conservatism has a role in accounting, but not in the form of qualitative characteristics. The concept of conservatism will serve to resolve problems regarding recognition and measurement within the conceptual framework. The concept of conservatism can solve the problem of determining whether it enters the balance sheet or profit or loss at certain times when the framework is weak. The concept of prudence will react when uncertainty occurs (such as a weak conceptual framework). The concept of conservatism will provide information to investors regarding investment returns, especially regarding the uncertainty of the investment. (Penman, 2016)

Under the concept of prudence, company management must not increase the amount of revenue recognized or underestimate the amount of expenditure. The management of the company must also be conservative in recording the number of assets, and not lowering liabilities. However, the results must be in the form of financial statements that are stated conservatively.

Everyone acknowledges that prudence is very necessary for accounting, therefore, its role must be recognized within the conceptual framework. This study wants to see the concept of conservatism or prudence in several countries.

2 LITERATUR STUDY

Agency Theory
Agency theory is a theory that arises because of a conflict of interest between the principal and the agent. Principal as the shareholder while agent as manager. Principals contract agents to manage resources within the company. In other words, the principal provides facilities and funds for the company's operations. The agent is obliged to manage the resources owned by the company, besides that the agent is also obliged to account for the tasks assigned to him. While the principal has the obligation to provide compensation for the tasks that have been charged to the agent.

Companies that separate management functions from ownership functions will be vulnerable to agency conflicts. The causes of conflict between managers and shareholders include making decisions related to fundraising activities and making decisions related to how the funds obtained are invested. Shareholders or owners who are assumed to be principals are only interested in increased financial results or their investment in the company.

Human nature is when information produced by humans for other human beings is always questioned about their rentability and can be trusted whether or not the information delivered. The choice of conservatism method is inseparable from the interests of managers to optimize their interests at the expense of the interests of shareholders.

Positive Accounting Theory
Positive accounting theory sees that managers, shareholders and stakeholders are rational people, and they will try to maximize their abilities and this will be related to compensation and welfare. The nature of a manager will definitely improve his welfare. Positive accounting theory will predict poor manager performance that can be covered by an increase in profit.

Conservatism Theory
Conservatism arises because of the tendency of the management to report net assets at the lowest value. Current conservatism is more associated with caution. Conservatism is a careful reaction to the inherent uncertainty in the company to try to ensure that uncertainty and inherent risks in the business environment are sufficiently considered. Risk uncertainty must be reflected in financial statements so that predictive and neutral values can be corrected. Careful reporting will benefit all users of financial statements.

If the company chooses one of the two existing accounting techniques, then an alternative that is less
profitable for shareholder equity must be chosen. The technique chosen is a technique that produces low asset and income values or that produces high debt value and costs. Consequently, if there are conditions that might cause losses, costs or debt, then the losses, costs, and debts must be recognized immediately. Conversely, if there is a condition that allows profit, income or assets, then profits, income or assets cannot be recognized immediately until the condition actually occurs. Conservatism is a pessimistic view of accounting. Conservative accounting means that accountants are pessimistic in the face of uncertainty in profit or loss by using the principle of slowing down revenue recognition, accelerating recognition of costs, lowering valuation of assets and raising debt valuations.

**Prudence Theory**

Another way to look at prudence is to simply record income or asset transactions when they are certain, and record transaction costs or liabilities when possible. Another aspect of the prudence concept is when company management tends to delay the introduction of income or asset transactions until company management feels confident about it. Meanwhile, company management will tend to record costs and liabilities as long as possible. In addition, company management will periodically check assets to see if the asset has decreased in value, and see whether the obligation has increased. In short, the tendency under the precautionary concept is not to recognize profits or at least delay their recognition until the underlying transaction is more certain.

Prudence is usually done in terms of arrangements, for example, allowance for doubtful accounts or reserves for obsolete inventories. In both cases, certain items that will cause costs have not been identified, but wise people will record reserves in anticipation of a reasonable amount of costs that arise at some point in the future.

Applicable accounting principles will combine the concept of prudence in many accounting standards, for example, requiring company management to write fixed assets when the fair value of the asset falls below its book value, but company management does not allow to write fixed assets when the opposite occurs. The International Financial Reporting Standard allows a revaluation of fixed assets and thus does not comply strictly with the concept of prudence.

Prudence is the convergence of accounting conservatism or which means the principle of prudence in recognizing income or assets and expenses that can result in minimizing the profits generated by a company to reduce the risk of uncertainty in the future. With the implementation of prudence by management, it will generate relatively small profits which are also a positive signal to investors, which means that they have implemented prudence to reduce information asymmetry within the company. And this will make investors more confident with recognized profits not overstating.

The relevance of information will give consideration and uncertainty to the measurement of an account compared to where the account is recognized first. Fair value is made based on the model of the value and uncertainty of future cash flows that must be recognized. The conclusion of the current IFRS example is that the conceptual framework requires an element of prudence when recognizing assets and liabilities not only to reflect measurement uncertainty. Prudence when recognition of assets and liabilities is more transparent than potential prudence at the time of measurement.

In measuring historical costs, for some accounts, it will provide a level of prudence for profit recognition and asset valuation. Fair value requires an honest application of measurement techniques. Accounting standards should not inject prudence elements in assessment because they will tend to provide biased measurements. Accounting standards should only provide guidance, even though reality actually involves measurement. This will make financial reporting uncertain and, management opinion will be an error and not prudence.

### 3 METHODOLOGY

The researcher conducted a literature study to find out how conservative and prudence concepts are currently in several countries. The researcher examines and collects conclusions from several journals related to the concept of conservatism and the concept of prudence.

### 4 RESULT AND ANALYSIS

Conservative accounting is an important principle that has long influenced financial statements. These past thirty years financial reporting has not only been conservative but has become increasingly conservative. Many benefits are obtained from conservative accounting reporting and proving that company managers get incentives to present financial reports in a conservative way even in the absence of rules or regulations that order conservative reporting. The concept of conservatism
reaps a variety of criticisms from standard compilers including academics.

Hsieh, Ma, and Novoselov conducted research on accounting conservatism. Hsieh, Ma, and Novoselov want to see whether accounting conservatism can be explained in a rational way to ambiguity. Companies that face financial reports with greater ambiguity, the company is more conservative. Hsieh, Ma, and Novoselov in their research looked at companies of two types of strategies namely "prospector" and "Defender". Companies whose strategy models are "Defender" will focus on utilizing existing resources, and companies whose strategy models are "Prospector" will look for new business opportunities. The results of his research are that companies that face greater report ambiguity will be more conservative. (Hsieh, Ma and Novoselov, 2018).

Within the conceptual framework, the concept of prudence must be maintained. The French Accounting Standards Authority and the Australian Accounting Standards Board (AASB) do not agree with reintroduction. The concept of prudence in financial reporting is permitted, where it will be useful for the need to protect the interests of investors in financial reporting. And, this also applies internationally and European countries. According to Măciucă, Hlaciuc and Ursache that as long as company management does not use the concept of prudence to maintain income or hidden reserves, prudence and other concepts will create a strong foundation for financial reporting. Therefore, the concept of prudence will not conflict with the neutrality of financial statements. Prudence accounting behavior is the quality of accountants in understanding the details of the basic accounting principles relating to asset valuation and profit measurement. (Măciucă, Hlaciuc and Ursache, 2015)

Geimechi and Khodabakhshi conducted research on the Tehran Stock Exchange and considered the size of the company based on assets. The results of Geimechi and Khodabakhshi’s research that there is no influence of company size on the concept of conservatism, discretionary accruals do not affect conservatism. the existence of the concept of conservatism is recommended in financial statements for the benefit of investors. (Geimechi and Khodabakhshi, 2015).

Amanamah and Owusu conducted research on the Ghana Stock Exchange. Accountants in Ghana are of the view that measurement based on fair value is useful, especially with regard to financial reporting. There is no active capital market for the recognition of certain assets facing many problems during implementation. In Ghana, there is no need for proper, quality and skilled assessment. And, it is not necessary for the Supervisory Board to help assess certain assets. Ghana's capital markets are inefficient to support fair value measurements. This is due to the challenges for developing countries where capital markets are inefficient in terms of conducting prudence concepts that must apply fair value. Ghana Stock Exchange is an inactive capital market for certain assets, lack of professional judgment and regulators. (Amanamah and Owusu, 2016).

Bahadir, Demir, and Oncel conducted a study of 90 companies listing on Turkey Stock Exchange. The application of IFRS is believed to be able to improve financial reporting by increasing the comparability, quality, and transparency of financial statements. However, the lack of guidance on IFRS implementation, inadequate sectors in adopting regulations and difficulties in applying the concept of fair value which is considered a major challenge for the implementation of IFRS in Turkey. (Bahadir, Demir and Oncel, 2016).

Smart planning can provide benefits to companies that may already have global competitors. It is recommended that corporate entities in Nigeria must adapt to International Financial Reporting Standards rather than complete adoption of standards. (Okoye and Akenbor, 2014).

The impact of harmonizing financial accounting standards (the application of IFRS, GAAP, and IAS), making the spread of fair value more widespread, means that the spread of the concept of prudence is also wider. The historical cost system, which is a conservative concept, is very popular in the European Union. The concept of prudence and fair value will make the capital market more transparent. But it has never been seen how this concept of prudence in developing countries (such as central and eastern Europe). For asset revaluation during financial ratio analysis, the ratio is not too sensitive to the application of the revaluation model but is very sensitive to the application of the fair value model. (Strouhal, 2015).

5 CONCLUSION

The concept of prudence will be able to help financial reporting so as to not give false optimism to users of information in the event of high uncertainty. The concept of prudence is only for general guidelines. In the end, use the best judgment...
of company management in determining how and when to record accounting transactions.

The concept used now is that Prudence is no longer conservatism. Conservatism is the concept if fortunately it must be acknowledged carefully, but if the loss is recognized immediately. But in the concept of prudence, income or profit is recognized if indeed the conditions have been fulfilled. For example in the Statement of Financial Accounting Standards, income, there are conditions when income can be recognized. When the terms of recognition of income have not been fulfilled, revenue cannot be recognized.

The concept of prudence and fair value will make the capital market more transparent. But it has never been seen how this concept of prudence in developing countries. This makes the concept of conservatism still be used for developing countries, so applying the concept of prudence has difficulty. Meanwhile, developed countries, the concept of prudence is more acceptable because it will make the capital market more transparent.

REFERENCES


