The benefits of recording losses first

Analyzing U.S. stock data over three decades, research suggests that conservative accounting practices lead to better information for stockholders.

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Recognize losses as soon as they are discovered and recognize gains only after they are verified. That is conservative accounting in a nutshell.

Conservative accounting is still controversial in some circles, yet Juan Manuel García Lara, Beatriz García Osma and Fernando Peñalva present strong evidence that conservatism on financial statements is useful for both debt- and equity-holders.

The results of more than 63,000 observations of U.S. stocks from 1977 to 2007 are published in their article "Information Consequences of Accounting Conservatism." On a practical level, Peñalva and co-authors find that conservatism improves the accuracy of equity analysts' forecasts, decreases the disparity between analysts' forecasts, and increases analyst coverage (i.e., the number of analysts following a particular stock).

The net gain to investors is better information to help make wiser capital-allocation decisions.

Conservative accounting can also help managers make optimal investment decisions for a firm, albeit more indirectly. That is because the incentives to engage in self-serving projects at the expense of investors are reduced when investors know about any losses up front.

The controversy surrounding conservative accounting

Because conservative accounting on financial reports incorporates losses sooner than gains, a cumulative understatement of net assets is the result. This is the origin of the controversy.

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The influential Financial Accounting Standards Board (FASB) of the United States and the International Accounting Standards Board (IASB) opposed the notion of conservatism in accounting, reasoning that may introduce a negative bias into financial statements where neutrality is more desirable.

Yet the authors, and many other parties, see more benefits than drawbacks to conservative accounting, as outlined below.

Improving information for all

The authors focus on whether conservatism reduces information asymmetries between a firm's insiders and outsiders. In other words, they ask if analysts and investors, as outsiders, can approach the level of accurate knowledge about a firm that its own managers and other insiders have.

In order to test the effects of conservative accounting on the information environment of a firm, the authors took a large sample of U.S. equities dating from 1977 to 2007. They observed what happened to a stock price's bid-ask spread, a stock price's volatility, analysts' forecast accuracy, analysts' forecast dispersion, and analysts' coverage levels in the year after a firm adopted more conservative accounting practices. They used several proxies for accounting conservatism to boost the strength of their findings.

With increased conservatism, they found lowered stock-price spreads and volatility — as well as signs of decreased information asymmetry. They found an improvement in analysts' forecast accuracy, a decrease in forecast dispersion and an increase in analyst coverage.

"All of these results are consistent with conservatism improving the information environment of the firm," they conclude.

Positive economic benefits

Previous research had already outlined the advantages of conservative accounting in debt contracting, where both lenders and borrowers benefit from increased transparency. Conservatism has also been credited with limiting earnings manipulation and enhancing disclosure.

These findings underline the authors' thesis that while debt markets have been identified as the main origin of the demand for conservative accounting, equity markets also stand to benefit from conservatism.

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By getting better information, information that is more similar to what insiders know, investors stand to profit from this research.

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