

# A renewed interest in conservative accounting

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## **To get the economy moving toward profitability, embracing conditional conservatism could be a step in the right direction.**

Business leaders are adjusting to the new economic realities brought about by the continuing global financial difficulties. In exploring new avenues to profitability and growth, all areas of company operations are on the table.

[IESE's Fernando Peñalva](#), together with Juan Manuel García Lara and Beatriz García Osma, researched the link between conditional conservatism and cost of capital. Their findings, "[Conditional Conservatism and Cost of Capital](#)," were published in the *Review of Accounting Studies*.

## **What is conditional conservatism?**

Conditional conservatism is an accounting practice that imposes more stringent verification requirements on economic gains than economic losses. This results in earnings that reflect losses in a timelier manner than gains, often called asymmetric reporting.

A company's commitment to timely reporting of low earnings realizations contributes to full disclosure of information, thereby reducing uncertainty. Full disclosure is achieved via timely recognition of losses in the audited financial statements. This is combined with strategic disclosure of good news through other communication channels, such as the notes to financial statements and conference calls. The final result is an improvement in information quality.

## **Impact on firm value**

By improving information quality, managers increase the precision with which market participants can assess future cash flows. This reduces the volatility of the firm's stock price and its cost of capital.

Cost of capital refers to the cost of a company's funds and is used to evaluate new projects. It represents the minimum return that investors expect for providing capital to the firm, thus setting a benchmark that any new project has to meet.

Lower cost of capital can put a company at a competitive advantage, allowing investment in more long-term projects and projects that carry greater risk.

Conditional conservatism is also expected to increase firm value indirectly through improved monitoring and contracting, and reduced litigation costs. The firm is better able to identify and remove poorly performing managers, as well as prevent managers from engaging in self-serving projects and expropriating investors. This, in turn, helps to boost the firm's investment efficiency and lowers agency costs arising from compensation and debt contracting.

## **Positive economic outcomes**

The authors' work adds to a flourishing stream of research showing that conditional conservatism leads to positive economic outcomes.

Without properly enforced conservative accounting, firm disclosure is less precise. This may lead to greater uncertainty, greater volatility of future prices, increased cost of capital and lower market values.

In sum, adopting a conditional conservatism approach can help firms to lower their cost of capital, and hence, compete more effectively, leading to more innovation, growth and job creation.

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