

CONSERVATISM CONCEPT IN ACCOUNTING AND A SEARCH ON COMPANIES TRADED IN ISE PUBLIC INDUSTRIAL INDEX

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Abstract

In this study, it has been mentioned that conservatism concept which is one of the accounting principles and searched that whether the companies traded in ISE Public Industrial Index are conservative or not, there is a relationship between financial success and conservatism in using statistical methods.

It is supposed that in the principal of study conservatism is an important principle of institutional management and accounting standarts and successful companies in the long run are also conservative.

It has been carried out that regression analysis to 51 companies' traded in ISE Public Industrial Index by using 16 years time series and result is following. Just one of 51 companies is conservative and financially successful companies traded in İstanbul Stock Exchange Public Industrial Index are not conservative.

Key Words: Conservatism, Accounting Standards, Institutional Management.

Introduction

Reliability of the accounting systems had become to be questioned specially after Enron around the world including Tukey as an emerging market. The importance of the corporate governance and a unique financial reporting standarts aorund the world has increased to prevent such cases.

Accounting standarts in the financial markets have been harmonized with the International Financial Reporting Standarts in 2003 to present more proper information to the financial statement user. Beginning from 2005 listed companies in ISE have been obliged to prepare financial statements eligible with IFRS.

Also some regulations have been ruled and continues to be ruled to make corporate governance be implied.

Making accounting reliably and harmonizing with corporate governance rules have located at the base of these efforts.

Conservatism, has is the most important concept affecting accounting applications, is one of the most important factors affecting the reliability of enterprises and

informations on financial statements. It is also an important factor for the success of the establishments at long term.

Because giving incorrect information on financial statements is against social responsibility. At this time, when everybody can easily acquire information, problems that couldn't be solved easily may occur. On the other hand companies those behaving harmonious with ethical rules and having social responsibility understanding would have been accepted and increase their values.

1. Concept of Conservatism

Conservatism has influenced accounting practice and theory for centuries. Historical records from early 15th century trading partnerships show that accounting in medieval Europe was conservative. Savary (1712) contains an early textbook discussion of the lower-of-cost-or-market principle. Since these practices predate income and property taxes, shareholder litigation, and accounting regulation, they cannot explain the origins of accounting conservatism.¹⁵

Conservatism is one of the most influential practical conventions underlying contemporary accounting since the beginning of this century. The concept of conservatism is, however, very controversial in accounting literature, and it has long been labeled as a "convention," instead of a "principle" or "standard" in accounting literature and official statements of accounting standards. Nevertheless, this concept has a wide application in accounting standards and practices today in most industrialized countries.¹⁶

In accounting literature, the notion of conservatism is to employ a less optimistic attitude in handling accounting transactions or events when varied alternatives are present. The basic implication of the convention was traditionally to "anticipate no profits but anticipate all losses". Therefore, a series of accounting procedures based on conservatism have been developed to account for provisional expenses and potential losses in accounting practice.¹⁷

Definitions depending on conservatism can be described in this order;

Accountants traditionally expressed conservatism by the rule "anticipate no profits but anticipate all losses".¹⁸

¹⁵ BASU, S., The Conservatism Principle and The Asymmetric Timeliness of Earnings, (1997) *Journal of Accounting and Economics*, Volume 24, p.8

¹⁶ LIN, Z.J., F. CHEN, Applicability of the Conservatism in China: Empirical Evidence, (1999), *The International Journal of Accounting*, Volume 34, No:4, p.517

¹⁷ LIN, Z.J., F. CHEN, a.a., p.518

¹⁸ BASU, S., a.a., p.7

The textbook definitions of conservatism are more descriptive. A typical one is that conservatism is the rule whereby & when there is a genuine doubt concerning which of two or more reporting alternatives should be selected, the alternative with the least favorable effect upon owners' equity should be chosen.¹⁹

2. Basics Of The Concept Of Conservatism

While the basics of the concept of conservatism observed contracts with the third parties composed the basics. Contracts is an important factor that makes information giving about establishment performance and net asset value.

Shareholder litigation has been advanced as potential explanations of conservatism too. The litigation theory is that conservatism emerges as an endogenous defensive response by managers and auditors to reduce the likelihood of being sued in a shareholder class action lawsuit.²⁰

Finally corporate regulations have been accepted as the reasons making establishments more prudent. Corporate regulations in Turkey have been made by Ministry of Finance, Security Exchange Commission, Ministry of Justice and Turkism Accounting Standarts Board. Because of the different approaches of these establishments some differences appear at applications.

3. A Research on the Listed Companies At ISE

In this section the aim, scope and limits and method of the research will be explained.

3.1. Aim of the Research

Conservatism is an important factor of the corporate governance idea and accounting standarts. From this importance a research was performed to determine the conservatism of the listed firms at ISE.

¹⁹ GIVOLY, D., H. CARLA, The Changing Time-Series Properties of Earnings, Cash Flows and Accruals: Has Financial Reporting Become More Conservative?, (2000), "*Journal of Accounting and Economics*", Volume 29, p.291

²⁰ CHANDRA, U., C.E. WASLEY, G.B. WAYMIRE, Income Conservatism in The U.S. Technology Sector, (2004), "*Working Paper*", No: FR 04-01, Rochester University, p.3

3.2. Range and limit of the Research

Listed 51 companies before the date of 31.12.1990 was included into the research to determine long term stability.

3.3. Method of Research

Approach that searches conservatism from the relation between profit per share and income per share was preferred.

This model was established on the supposition on that companies would be more conservative to reflect possible expenses and loss than possible income and profit. Companies should determine possible expenses and loss in the accounts. So companies could inform statement users before the negative events. There will be a difference between market and financial statement conditions if statement users arrive informations in an other way.²¹

In addition companies shouldn't determine possible income and loss in accordance with conservatism. Again there will be a difference between market and financial statement conditions if statement users arrive informations in an other way. The reason of the difference is the present buy and sell of the good news.²²

If the difference between real condition and market condition is reasoned from the unacceptance of the possible expenses and loss, this is a negative condition. But if it is reasoned from the unacceptance of the possible income and profit, this is a normal condition and isn't againts of conservatism.

In this sense the relation between profit per share and income per share would be stronger in negative times when bad news realized compared with positive times. Because companies should transfer negative conditions to the financial statements in bad times.

Consider the following OLS estimation of the equation:²³

$$\frac{X}{P_{t-1}} = a_0 + a_1DR + b_1R + b_2R*DR + e$$

X: the current earnings per share,

P_{t-1}: closing stock price for the previous period end,

²¹ BASU, S., a.a., p.12

²² BASU, S., a.a., p.12

²³ SEETHARAMAN, A., B. SRINIDHI, Z.L. SWANSON, An Empirical Assessment of the Effect of the Legal Environment on Accounting Conservatism, (2006), "American Accounting Association 2006 Annual Meeting", Washington, D.C., p.10

$$R: \frac{\text{the return for the period}}{\text{closing stock price for the previous period end}}$$

DR: an indicator variable with value = 1 if $R < 0$ and 0 otherwise,

Coefficient a_1 represents the effect of negative returns on the intercept and b_2 represents the effect of negative returns on the slope. Conservative reporting must lead to a positive value of b_2 . Higher the value of b_2 , greater is the conservatism. Basu argues that the intercept a_0 is positive because the previously realized but unrecognized gains will be recognized in this period and news is, by definition, uncorrelated over time.²⁴

Besides adjusted R^2 s from separate regressions on the two samples indicate that the explanatory power of negative returns must be greater than positive returns. These results are consistent with earnings being more timely or concurrently sensitive in reporting publicly available bad news than good news.²⁵

During the research hypotheses of regression have been examined and rate of reliability has been accepted as 95 %.

3.4. Results of the Research

As it is seen in Table 1 among researched 51 companies, only Izocam has been determined as conservative.

²⁴ ROYCHOWDHURY, S., R.L. WATTS, *Asymmetric Timeliness of Earnings, Market to Book and Conservatism in Financial Reporting*, (2006), "MIT Sloan Research Paper", No. 4550-05, Cambridge, p.17

²⁵ BASU, S., a.a., p.13

Table 1: Whether Businesses Conservatism Or Not

CODE	NAME	*	**	***	****
AKALT	Ak-Al Tekstil	Meaningless	-	-	Not conservative
AKSA	Aksa Akrilik Kimya	Meaningful	Meaningless	-	Not conservative
ANACM	Anadolu Cam	Meaningless	-	-	Not conservative
ARCLK	Arçelik	Meaningful	Meaningless	-	Not conservative
AYGAZ	Aygaz	Meaningless	-	-	Not conservative
BAGFS	Bagfaş Bandırma Gübre	Meaningful	Meaningless	-	Not conservative
BFREN	Bosch Fren Sistemleri	Meaningful	Meaningless	-	Not conservative
BOLUC	Bolu Çimento	Meaningless	-	-	Not conservative
BRISA	Brisa Bridgestone Sabancı Lastik	Meaningless	-	-	Not conservative
CELHA	Çelik Halat	Meaningless	-	-	Not conservative
CIMSA	Çimsa Çimento	Meaningful	Meaningless	-	Not conservative
DENCM	Denizli Cam	Meaningless	-	-	Not conservative
DEVA	Deva Holding	Meaningless	-	-	Not conservative
DOKTS	Döktaş Dökümcülük	Meaningless	-	-	Not conservative
DYOBY	Dyo Boya	Meaningless	-	-	Not conservative
ECILC	Eczacıbaşı İlaç	Meaningless	-	-	Not conservative
EGEEN	Ege Endüstri	Meaningless	-	-	Not conservative
EGGUB	Ege Gübre	Meaningful	Meaningless	-	Not conservative
EREGL	Ereğli Demir Çelik	Meaningless	-	-	Not conservative
FENIS	Feniş Alüminyum	Meaningful	Meaningless	-	Not conservative
FMIZP	Federal-Mogul İzmit Piston Pim	Meaningless	-	-	Not conservative
FROTO	Ford Otomotiv	Meaningless	-	-	Not conservative
GENTS	Gentaş Genel Metal	Meaningless	-	-	Not conservative
GOODY	Goodyear Lastikleri	Meaningful	Meaningless	-	Not conservative
GUBRF	Gübre Fabrikaları	Meaningless	-	-	Not conservative
HEKTS	Hektaş	Meaningful	Meaningless	-	Not conservative
IZMDC	İzmir Demir Çelik	Meaningless	-	-	Not conservative
IZOCM	İzocam	Meaningful	Meaningful	True	Conservative
KARTN	Kartonsan Karton	Meaningless	-	-	Not conservative
KENT	Kent Gıda Maddeleri	Meaningless	-	-	Not conservative
KLBMO	Kelebek Mobilya	Meaningful	Meaningless	-	Not conservative
KONYA	Konya Çimento	Meaningful	Meaningless	-	Not conservative
KORDS	Kordsa Sabancı Dupont Endüstriyel	Meaningful	Meaningless	-	Not conservative
KUTPO	Kütahya Porselen	Meaningless	-	-	Not conservative
MRDIN	Mardin Çimento	Meaningful	Meaningless	-	Not conservative
MRSHL	Marshall Boya	Meaningless	-	-	Not conservative
OLMKS	Olmuksa International Paper	Meaningless	-	-	Not conservative
PARSN	Parsan Makina Parçaları	Meaningless	-	-	Not conservative
PETKM	Petkim Petrokimya Holding	Meaningful	Meaningful	False	Not conservative
PIMAS	Pimaş Plastik İnşaat Malzemeleri	Meaningless	-	-	Not conservative
PINSU	Pınar Su	Meaningless	-	-	Not conservative
PNSUT	Pınar Süt Mamulleri	Meaningful	Meaningless	-	Not conservative
PRKAB	Türk Prysmian Kablo Sistemleri	Meaningful	Meaningless	-	Not conservative
SARKY	Sarkuysan Elektrolitik Bakır	Meaningful	Meaningless	-	Not conservative
TBORG	T. Tuborg Bira Malt	Meaningless	-	-	Not conservative
TRKCM	Trakya Cam	Meaningless	-	-	Not conservative
TUDDF	Türk Demir Döküm	Meaningful	Meaningless	-	Not conservative
UNYEC	Ünye Çimento	Meaningful	Meaningless	-	Not conservative
USAK	Uşak Seramik	Meaningful	Meaningless	-	Not conservative
VESTL	Vestel Elektronik	Meaningless	-	-	Not conservative
YUNSA	Yünsa Yünlü	Meaningless	-	-	Not conservative
* The meaningfulness of the model on 5 %.					
** The meaningfulness of the interaction variable on 5 %.					
*** The rate of declaration in the time of bad news.> The rate of declaration in the time of good news.					
**** whether businesses conservatism or not.					

4. Results and Proposals

Accounting scandals in recent years caused the diminishing of the reliance to the accounting systems. The reason of this reliance depression is U.S.A. that is thought accounting standarts and market mechanism worked properly. Reliance depression started in U.S.A. affected other markets in time and have obliged regulation to be done around the world.

Prior changes until now is the harmonization is financial reporting standarts and corporate governance rules. With this two steps market reliance tried to be regained and prevent new scandals.

As an emerging market Turkey has been affected from this wave and listed companies at ISE was obliged to prepare statemets in accordance with IFRS.

Also there has been regulations on corporate governance. Capital Markets Board issued corporate governance rules in 2003. And ISE composed a corporate governance index.

But these changes are insufficient for a good working capital market. Lowness of the listing ratio and listed company number is the sign of long way of Turkey. Conservatism is a good concept for the for these efforts. Specially this concept came forward among other concepts.

In accordance with research Izocam is conservative. All of the 50 enterprises other than Izocam aren't conservative.

In order to improve this condition getting into a more reliable and stable structure is a must. These efforts will provide minimization of capital cost and distribution capital to the base.

Correct perception of the IFRS and Corporate Governance is a must for conservatism concept. These proposals should be considered to improve correct perception of conservatism;

- Corporate governance rules should be obligatory to implement than being voluntary
- Establishment of a system that will provide fast and fair judgement of managers of the companies that doesn't prepare financial statements reliably.
- Providing the cooperation of the boards and good market processing
- Controlling of the auditing firms
- Providing a good information quality for good competence and governance
- Increasing the efficiency of internal auditing facilities

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