CHAPTER 6

Conclusion and Implications

6.1 Conclusion

This study aimed to investigate the role of accounting conservatism and management earnings forecasts in the Thai capital market. The first objective examined the relationship between accounting conservatism and biases in management earnings forecasts. The second objective investigated the effects of accounting conservatism on stock market reactions to management earnings forecast disclosures. The third objective looked into the effects of accounting conservatism on the relationship between asymmetric information and the stock market's reactions to management earnings forecast disclosures. The sample comprised of Thai listed firms that disclosed management earnings forecasts during the years 2005-2012.

Conservative financial reports play a role in a firm's efficient contracts and governance accounting procedures (Watts 2003). These reports were found to be influenced by the control of agency costs related to asymmetric information (Watts 2006; LaFond and Watts 2008). Shareholders demand that firms use conservatism to monitor and govern the firm's managers (Healy and Palepu 2001; Watts 2003; Armstrong, Guay, and Weber 2010). Similar to conservative reports, earnings forecasts issued by corporate managers are used by market participants (i.e., shareholders and investors) to evaluate firms' future performances and future cash flows. Since audited financial statements (i.e., conservative reports) and management earnings forecast information (i.e., voluntary disclosure) have complementary or substitute relations in their effects and benefits, their relationship is worth studying. To provide comprehensiveness to the study of the relationship between the two, the information roles of conservatism and management earnings forecast on capital markets (i.e., returns) were further studied.

6.1.1 Accounting conservatism and management earnings forecast biases

For the first research objective of this study, a total of 1,016 firm-years of Thai listed companies that completed financial and accounting data sets during the period of 2000-2012 were collected for testing research hypothesizes. Past findings showed that managers have motivations that cause an overestimation of their firm’s financial performance by accelerating the disclosure of good news while slowing down bad news announcements (Ball 2009; Kothari, Ramanna, and Skinner 2010; Core, Guay, and Verrecchia 2003). The managerial tendency to conceal bad news from outside investors may lead to biases in management earnings forecasts (Baginski, Hassell, and Kimbrough 2002; Rogers and Stocken 2005). Conservatism is predicted to mitigate such managements’ asymmetric disclosure incentives and adverse selection problems by restraining management’s tendencies and abilities to withhold bad news and overstate earnings with the purpose of reducing the likelihood that the firm’s forecast earnings will systematically overestimate the probability of good firm performance.

This study found that higher degree of accounting conservatism was significantly and positively associated with lower management’s optimistic forecasted biases. The results suggest that, for firms with higher conservative reports, corporate managers tend to forecast annual earnings less optimistically or not highly overestimate the figures in comparison to firms with lower conservative report. This finding supports the prediction of this study and is consistent with the widely accepted concept that conservative reports increase the contractual efficiency of accounting information by constraining management’s opportunistic behaviour and mitigate adverse selection problems (Basu 1997; Watts 2003, 2006; LaFond and Watts 2008). Furthermore, the evidence from this study are aligned with Hui, Matsunaga, and Morse’s (2009) study in which they concluded that managers adjust their forecast properties according to the degree of conservatism in the firm’s accounting system.

More importantly, results indicated that the magnitude of management forecast bias (or absolute forecast error) was smaller when conservative accounting was relatively high. This result confirms the monitoring and governing roles of conservative reports over agency costs (Watts 2006; Armstrong, Guay, and Weber 2010). Based on the analysis of sample firms with earnings forecasts that were greater than actual earnings, which are categorized as "optimistic firms," it was consistently found that forecast bias decreased accordingly with the degree of conservatism in these firms. Conversely, sample firms with forecasted earnings that were smaller than actual earnings, categorized as "pessimistic firms," the magnitude of management forecast bias was found to be significantly higher in more conservative firms. A plausible reason is that managers of pessimistic firms tend to commit to applying highly conservative accounting policies and to retain forecasts less aggressively. These research findings signify that the role of conservative accounting when contracts are made (*ex-ante* contracting) is to provide future information to investors. The main issue in supplying information is not with timeliness so as to help in better decision-making; rather, the aim is at controlling agency costs (Watts and Zimmerman 1986; Gigler and Hemmer 1998; Ball, Robin, and Sadka 2008; Ball, Jayaraman, and Shivakumar 2012).

In addition, this study investigated to see if the relationship between conservatism and management forecast biases was affected by the degree of operational uncertainty. The results showed that the positive relationship between management earnings forecast biases and conservatism was less pronounced among firms operating in a more uncertain business environments. This finding is aligned with the conjecture that managers who are confronted with more uncertain operating environments make greater cognitive biases in assessing the firm's future business prospects (Hirshleifer 2001; Zhang 2007). The finding is also consistent with the previous empirical study that suggested that in the event of higher uncertainty in operations, firms with a greater degree of conservatism experience a high instance of optimistic forecasts (Sun and Xu 2012).

Furthermore, this study found that the relationship between management earnings forecast bias and conservatism was more recognizable when the number of outside directors was high. However, board size was found to have a negative impact on the relationship between management earnings forecast bias and conservatism while the significance in the effects of CEO/Chairman separation on the relationship was not found. The results suggest that the employment of outside directors is a governance mechanism that increases the accuracy of management earnings forecasts and facilitates the implications of conservatism in the earnings forecast process.

A concurrent accounting research conducted by Sun and Xu (2012) examined if earnings forecasts that had been publicly disclosed by managers reflected the full use of information acquired from conservative reports. By testing US companies during the period of 1996-2009, they found that firms with a greater degree of conservatism experienced high instances of optimistic forecasts. They concluded that prediction difficulties were caused by the firms' operational volatility which refrained managers from fully incorporating information contained in conservative reports into their forecasted earnings.

While this current study found that management forecasts exhibited less optimistic tendencies when conservative accounting was relatively high, it is in line with Sun and Xu's (2012) study on the part where it confirms that accounting conservatism plays an important role in managers' forecasted earnings. More importantly, this study developed hypotheses built on the perspective that managers use both conservative reports and earnings forecast information to provide signals concerning their firm's future prospects and to decrease information asymmetry among market participants. The analyses on the moderating effects of operational uncertainty and governance structure proxies also support the main predictions of the contracting role of conservative reports. Because the Thai Accounting Standard (TAS) complies with the International Financial Reporting Standards (IFRS), the empirical findings from this study can be compared with prior studies conducted in developed countries.

6.1.2 Accounting conservatism and market reactions to earnings forecasts disclosure

The second objective of this study was to examine if market reactions to earnings forecasts disclosure varied according to the differences in degree of accounting conservatism. The sample used to test this objective comprised of 923 firm-years of Thai listed firms. In reference to confirmatory hypothesis and disclosure literature (Ball, Jayaraman, and Shivakumar 2012; Healy and Palepu 2001), this study predicted that firms utilizing a greater degree of accounting conservatism would display less reductions in stock returns when earnings forecasts were disclosed. Results in Table 14 indicated that, based on cumulative abnormal (or excess) returns in a three-day window around the period of management earnings forecasts disclosures, firms with higher degree of conservatism have larger cumulative abnormal returns than firms with lower degree of accounting conservatism. The empirical finding, thus, supports existing financial disclosure literature and confirms the hypothesis that high earnings quality (i.e. conservatism in accounting) and management voluntary disclosure (i.e., management earnings forecasts), complementarily influence stock market returns (Ball 2001; Healy and Palepu 2001; Penman and Zhang 2002; Ball, Jayaraman, and Shivakumar 2012).

Past research posited that conservatism contributes to the reduction of agency costs incurred when information asymmetry between managers and investors exists (Watts 2003; LaFond and Watts 2008). Based on this argument, this study extended current knowledge by examining the relationship between information asymmetry and declines in stock returns at the time of management forecast disclosure to see if the relationship was weaker for firms with greater degree of accounting conservatism. As shown in Table 15, this study found that decreases in stock returns when management earnings forecasts were disclosed were larger when information asymmetry was pronounced. From the research finding, this negative association between cumulative abnormal returns and information asymmetry is mitigated for firms with a greater degree of accounting conservatism. The results agree with the notion that accounting conservatism attenuates adverse consequences arising from information asymmetry (Watts 2003; LaFond and Watts 2008), and thus reduces agency costs that may exist around the management earnings forecast disclosure period. In other words, the findings suggest that market participants perceive conservative reporting as a financial report governance mechanism in firms with asymmetric information. Hence, market perception is reflected in the increased cumulative abnormal returns around management earnings forecast disclosure dates.

In summary, the analysis of the effects of accounting conservatism on cumulative abnormal returns suggests that accounting conservatism improves the relationship between management's disclosure decisions and the perspectives of market investors toward the credibility of management forecast information. This study provides evidence consistent with the notion that accounting conservatism serves as an effective mechanism for alleviating the adverse selection problems in disclosing firm-specific information related to the manager's business prospects. In addition, this study provides evidence supporting the conclusions made by Watts (2006) and Ball, Jayaraman, and Shivakumar (2012) on the confirmatory role of financial reporting (i.e., conservative financial reporting) that the firm will commit to credible voluntary disclosure of management forecast information.

6.2 Implications

The empirical findings of this study are meaningful to academicians, investors, financial practitioners, regulators and accounting standard setters. The empirical analyses provide several contributions to existing academic literature. First, the results add to the current research on the implications of accounting conservatism in management earnings forecasts. The empirical findings extend Hui, Matsunaga, and Morse's (2009) study by providing additional evidence that the manager's forecasted optimism declines with conditional conservatism. The findings offer additional evidence that the asymmetric verification requirements of conservatism offsets a manager's tendency to withhold bad news and accelerate good news when issuing management earnings forecasts. Consequently, managers can convey expected earnings information in accordance with financial conservative reports, which leads to less exaggerated estimates of a firm's future performances. More importantly, the findings of this study support the notion that conservatism increases the contractual efficiency of accounting information (Basu 1997; Watts 2003). The results of this study can help scholars in examining other perspectives of accounting research to better understand the general influences of conservative accounting and its particular effects on voluntary disclosures.

Second, the empirical findings on the effect of operational uncertainty indicate that the role of conservatism in mitigating management's asymmetric disclosure incentives and adverse selection in management earnings forecasts is attenuated for firms that operate in a business environment with greater uncertainty. A higher degree of uncertainty in the business environment tends to increase the amount of cognitive biases among managers (Hirshleifer 2001), leading to management's incentive problems. Although conservative accounting policy is employed to weaken the harmful effects of selection problems that are caused by managers' self-serving motivation and information asymmetry but in the situation of high uncertainty, managers still have their own judgments and discretions in disclosing information that would influence the credibility of management earnings forecasts. Therefore, regulators should be concerned about these issues when they release disclosure guidelines for voluntary disclosure for listed companies in the future.

Third, this study extends current literature on the relationship between mandatory and voluntary disclosures, labeled as the confirmatory hypothesis, which was proposed by Ball (2001), and Ball, Jayaraman, and Shivakumar (2012). The findings of this study revealed that conservative reporting (which is mandatory reporting or hard information) and management earnings forecasts (which are voluntary disclosure or soft information) both involve a high degrees of asymmetric information and managerial incentive problems (Ball, Jayaraman, and Shivakumar 2012; Armstrong, Guay, and Weber 2010). The mandatory disclosure information can be used as a threshold in constraining voluntary disclosure biases, which potentially enhances the incremental informational value of voluntary management forecasts (Ball 2001). Therefore, the empirical finding from this study can help in the investigation of the confirmatory hypothesis and substitute hypothesis in another context.

Fourth, findings from this study contributes to the research on the implications of accounting conservatism of companies in Thailand. There is a lack of consistency in prior research with respect to conservative financial reporting practices. Ball, Robin, and Wu (2003) examined conservatism practices of four East Asian Countries (Hong Kong, Malaysia, Singapore and Thailand) during the period of 1984 to 1996. They found that earnings reports of Thai firms were not more timely in recognizing bad news as losses than good news as gains. On the other hand, Bushman and Piotroski (2006) studied 38 countries, including Thailand, during 1992 to 2001. The study provided evidence that earnings reports of Thai firms used accounting conservatism in recognizing bad news relative to good news. The more recent work of Boonlert-U-Thai and Kunitsook (2009) found evidence consistent to that of Bushman and Piotroski (2006) that earnings reports of Thai listed firms were more conservative.

While prior studies yielded inconclusive results in respect to conservative reports of Thai listed firms, this study found a degree of conservatism in financial reports of sample firms during 2004-2011. As shown in this study, the average degree of conservatism (*C_SCORE*) was significantly different from zero. In addition, the degree of non-operating accrual measure of conservatism gradually increased during the study period. Thus, the findings supports prior research (i.e., Boonlert-U-Thai and Kunitsook 2009) that the financial reports of companies in Thailand are conservative. Specifically, the degree of conservatism sharply increased in the 2008 to 2009 period and the subsequent year. A plausible reason is that the global financial crisis in year 2008 stimulated Thai companies to apply conservative accounting policies, such as the recognition of probable liabilities versus the non-recognition of contingent assets, or the impairment for financial assets and long-lived assets.

The findings of this study have implications and raise concerns to related parties as follows. The research findings can serve as a guideline for corporate managers in deciding of whether or not to make aggressive or non-aggressive forecasts. In addition, the empirical evidence from this study provides more details in managerial disclosure biases and conservative accounting policy. They serve as a reporting mechanism that managers can refer to as a guideline in issuing earnings forecasts that accompany audited financial statements, particularly under conditions of uncertainty in the business environment and when degrees of corporate governance are different. Furthermore, empirical findings can help increase the abilities of managers and the credibility of earnings forecasts by incorporating the impact of conservative reports – both of which build investors' confidence on the credibility of management voluntarily earnings forecasts and decrease the scrutiny from regulators.

In addition, the research findings also have implications for equity investors, shareholders and financial analysts. Because only verified economic gains are realized in in financial statements under conservative reporting, the verified accounting information can be seen as the point of reference for other available sources, such as management earnings forecasts. The verified information provides investors with the ability to compare several forecasts against the accounting figures stated in audited financial statements (disclosure effect). The implication from the research results provide investors, shareholders and financial analysts with guidelines in *i*) evaluating the accuracy and credibility of earnings forecasts issued by managers, *ii*) assessing corporates' future performances, *iii*) evaluating firms' equity value, as conservatism provide lower bound measures, and *iv*) monitoring managers' investment activities. More importantly, investors can use the empirical findings to generate cautious estimations under conditions of uncertainty in the business environment to encounter corporate managers' discretionary disclosures. Similar to uncertain business situations, managers are influenced by several personal incentives that lead to biases when making estimates for financial reports and earnings forecasts.

Finally, the findings from this study also have implications for accounting standard-setting bodies. An important issue in the debate on accounting standard setting is the extent to which certain longstanding attributes of financial reporting, such as conservatism, should be included as part of the generally accepted accounting principles (GAAP) and the Conceptual Framework for Financial Reporting (Kothari, Ramanna, and Skinner 2010). The IASB and the Financial Accounting Standards Board (FASB) explain that conservatism is considered to be in conflict with neutrality and can introduce biases into financial statements, as stated in the Conceptual Framework for Financial Reporting (2010 revision). However, in a revised publishing of the exposure draft of Conceptual Framework for Financial Reporting in May 2015, it was proposed by the IASB to reintroduce the concept of prudence (also termed conservatism) to increase the utility of financial statements for investors (IASB 2015; Cooper 2015). Although the Conceptual Framework does not refer to conservatism in an explicit manner, mechanisms that relate to the employment of conditional conservatism, such as, the lower costs or net realizable values for inventories (IAS 2), the recognition of probable liabilities versus the non-recognition of contingent assets (IAS 7), or the impairment for financial assets and long-lived assets (IAS 39 and IAS 36) are included in the IFRS (Barker and McGeachin 2015).

Many academic scholars also suggest that accounting standard-setters should reconsider the demand for conservatism and consequences of conservative reports because financial reports serve as a primary source of information for outside stakeholders. These external parties would want access to information regarding the firm's valuation (the valuation role) and managerial performance evaluation (stewardship role) to make better investment decisions and to monitor managements' investment decisions (Watts 2003, 2006; LaFond and Watts 2008; Kothari, Ramanna, and Skinner 2010; Francis, Hasan, and Wu 2013; Andre, Filip, and Paugam 2015).

From the investor perspective, the reasons behind why investors prefer conservatism in the firms' financial statements are not limited to only acquiring the most relevant accounting information and being aware of the most accurate representation of the reporting firms' activities (Watts 2006; Cooper 2015). Instead, investors hold that the financial statements should consider other consequence of the reported figures have, such as how the financial statement information allows to determine how much dividends shareholders receive, the amount of bonus management should get, and how much capital a company should maintain (Cooper 2015). For each individual situation, the overestimation of net assets and earnings have more harmful effects than if the figures were underestimated. The investors believe that the differences in the impact of the consequences should influence an asymmetry of accounting (Watts 2006; Barker and McGeachin 2014; Cooper 2015). Therefore, it could be inferred that the demand for conservatism is driven by market force.

Findings from this study demonstrate that conservative reports are positively associated with cumulative abnormal returns around management forecast dates which reflects the benefits of conservatism in capital market, which links to the investor perspective. In addition, the negative relationship between information asymmetry and stock market reactions to earnings forecasts tend to be weaker for firms with a greater degree of accounting conservatism. These results indicate that conservatism mitigates moral hazard (managerial incentive problems) and adverse selection problems caused by asymmetric information. Taken together, the results from this study provide empirical evidence for accounting standard-setters on the role of conservatism in the emerging market setting. The findings support the proposal put forward by the IASB and provide evidence through this study that conservatism offsets managerial tendencies to withhold bad news and accelerate good news when issuing management earnings forecasts, increasing the welfare of investors as a result.

6.3 Future research

The research topic on conservative accounting continues to be an interesting topic in accounting research. One reason is that there is still much debate surrounding the economic consequences of conservative financial reporting in empirical literature. This study concentrates on the relationship between accounting conservatism (mandatory financial reporting) and bias in management earnings forecasts (voluntary disclosure). In addition, this study focuses on the consequences of conservative financial reporting and management earnings forecast disclosure on stock returns. A further study on conservative financial reporting and models of equity valuation should complement the findings of this study in understanding the implications of conservatism in valuation analysis. Lastly, the dataset used in this study were acquired in Thailand. Additional studies in similar emerging market contexts should be beneficial in making comparative contributions.