Department of
Economics and Finance

Revisiting the accruals loss recognition model of conservatism: are public companies really superior to private companies?

Abstract

The accruals based loss recognition test is the leading test to measure conditional conservatism in unlisted companies. It posits that conservatism is reflected in the anticipation of future losses which in turn lessens the negative relation between accruals and cash flow. Prior work using the model consistently finds that private companies act less conservatively than public companies. We argue that the test captures two aspects of accruals which are in fact unrelated to loss recognition: first, an increase in accruals due to the lengthening of the operating cycle; and secondly, a reduction in accruals due to a decline in sales. The former is particularly likely to affect private companies, which may explain why they appear to behave less conservatively than public companies.

We propose a variation of the accruals test, the profit margin test, which removes these two unwanted tes wh

1. Introduction

Prospects of future cash flow to the entity is a key quality of accounting information, IASB (2018). When a company has current information suggesting a reduction in the present value of its expected future cash flows, then it is important that this econoin loss is reflected in the measurement of accounting income on a timely basis. This objective is reflected in the conditional conservatism principle, whereby the recognition of bad news requires a lower degree of verification than good news ici42.6 (t)-

Shivakumar (2005) and compare the conservatism between public and private companies in the UK. We compare the profit margin test with the accruals test, based on a sample of over 1.2 million observations of UK companies between 2001 and 2018. Using the accruals test, we replicate the findings in prior research that public companies act more conservatively than private companies. However, the profit margin test reverses this result, indicating that, on an average level, private companies act more conservatively than public companies. The same results are

since it takes no account of the underlying sales volatility. With respect to employment growth (EGR), a reduction in the workforce of a company is likely to be a last resort response due to its large effect on the organization.

These reservations are reflected in the results (Byzalov and Basu, 2016, Table 3). There is very little difference between their results from equations 2/2a and the equation 1 specification where only current cash flow contains information about future performance. Even in the disaggregated variant, in which each variable containing information about the future has its own shift coefficient, the rise in R^2 is very little. It thus appears that

Differential responses may well be the case when comparing public and private companies. For example, a small private company may act conservatively in the presence of negative cash flow, thus

4.1 Overview of the approach

It is clear that accruals will be affected by conservatism. However, as argued above, modelling conservatism through the shifting relation between accruals and cash flow gives rise to two issues. First, accruals may be influenced by other factors which change contemporaneously with negative cash flow, such as an increase in the operating cycle. Secondly, the relation between accruals and cash flow is also affected by declining earnings, as the whole relation shifts downwards. However, not all of the decline in earnings can be attributed to conservatism; some of it may be due to a decline in activity. This activity effect interferes with the estimate of conservatism. For these two reasons it is difficult to capture conservatism by examining the relation between accruals and cash flow.

In this section, we go back to basics and try to identify another approach. We start with the definition in equation 3 that accruals are defined as earnings less cash flow. If equation 3 were estimated by regression, the coefficient on CFO should be -1. Our approach is to safeguard this characteristic of the relation between accruals and cash flow; we transfer cash flow to the other side of the equation to give equation 4, below. In order to make this definition operational and to capture conservatism, we follow the Dechow, Kothari, and Watts (1998) model of earnings, accruals and cash flows and specify earnings as the product of the profit margin and sales, shown in equation 4a,

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$$'_{Ü} = è_{Ü} 5_{Ü} \qquad (4a)$$

where $<_i$ is the profit margin, and S_i is sales for company i. Conservatism is then captured by changes in $<_i$ when cash flow is negative[2]. This measure is unaffected by changes in the operating cycle related to conservatism, and by changes in the level of activity.

4.2 The profit margin measure of conservatism

In order to estimate the changes in the profit margin, we regress earnings on sales for positive cash flow as in equation 5,

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regression give the difference between actual and expected earnings for a given level of sales; in a regression, the average of the residuals is defined to be zero.

comprising of 22,559 for public companies and 1,232,596 for private companies. During the period, public companies reported initially under UK GAAP and from 2005 under

the entire sample period, the slope coefficient when cash flow is positive (t_2) is -0.559 which increases by 0.308 when cash flow is negative. In contrast, for private companies over the same period, the t_2 coefficient is 0.173, which becomes more negative by -0.271 when cash flow is negative. Thus it would seem that public companies are more conservative than private companies. This result is very similar to that in Ball and Shivakumar (2005, Table 5, REGN I). As illustrated in Figure 2 and common with other studies, Table 2 finds a t_2 coefficient greater than minus one (the theoretical value for an individual company) indicating that companies with higher cash flow relative to accrual [illegible]

accruals based results of the Ball and Shivakumar (2005) equation in Table 2, which indicates greater loss recognition by public companies.

5.3 A comparison of positive and negative deviations ~ 4 ‹ •

We find in Table 3 above that when cash flow is negative, the change in the profit margin (4 ‹) is more negative for private companies. If this reflects differences in conservatism, then it should be driven largely by negative values of the deviation. The reason why negative cash flow is hypothesized to be associated with conservatism is that the former acts as a signal of economic loss, that smaller than expected cash flows are likely in the future. Thus it would be surprising if the differences between public and private companies were driven by positive deviations, by companies performing better than average. We examine this next in Table 4, where we partition the average deviation 4( ) in to its positive and negative components. A positive (negative) deviation is where earnings is above (below) the level indicated by sales volume.

Table 4 here

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movements which are unrelated to performance. However, when cash flow becomes negative, conservative accounting may anticipate further poor performance by a provision, reduction of accruals, in the current period. In this circumstance, since cash flow and accruals are moving more in the same direction, there will be less of a negative relation. Specifically, in a regression of accruals on cash flow, the slope coefficient will increase (become less negative) when cash flow is negative. Prior empirical evidence supports these expectations.

It is also found that in this respect public companies act more conservatively than private companies on an average level. This difference is explained firstly by the need of managers to inform shareholders of public companies in order to reduce agency costs, and secondly by the ability of private companies to provide soft information outside of the accounts to lenders, reducing the need for conditional conservatism in the accounts. However, this explanation is questioned in prior research, theoretical models suggest that there may be more efficient ways of deal

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Figure 1:

Figure 2: The accruals conditional conservatism test in the accruals-cash flow space

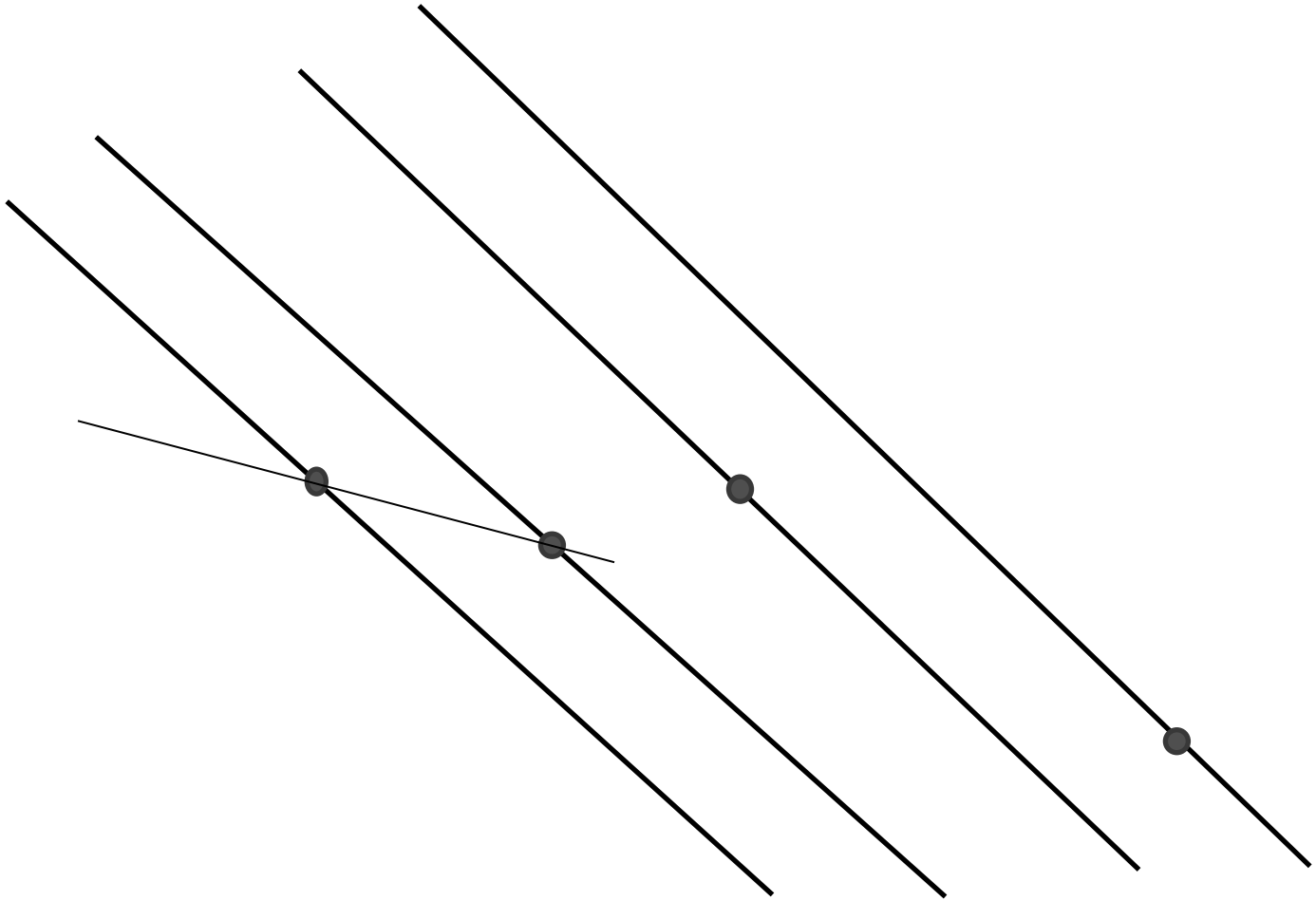

Table 1: Des3

Table 2: The relation between accruals and cash flows for public and private companies

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Panel B: Private Companies

Year	&% (1 (Ú)	% (1 (Ú)	&% (.1% (1 (Ú)	%K JD=J P (Ú)	No. of Obs.	R^2
2001	0.112*** (27.30)	-0.200*** (-26.49)	-0.201*** (-10.91)	-0.0368*** (-17.80)	47,069	0.309
2002	0.104*** (26.59)	-0.213*** (-30.81)	-0.184*** (-10.42)	-0.0345*** (-18.04)	51,918	0.315
2003	0.0956*** (25.78)	-0.200*** (-31.04)	-0.239*** (-14.45)	-0.0298*** (-15.97)	56,208	0.317
2004	0.108***	-0.170***	-0.259***	-0.0326***		

Panel B: β_{ij} β_{ij} are estimated over the entire period

	Public Companies	Private Companies

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Table 4: The profit margin test with positive and negative deviations (¿Ê.)

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Panel A: ½ ½ are estimated based on individual years

	Positive ¿Ê.						Negative ¿Ê.					
	Public Companies			Private Companies			Difference	Public Companies			Private Companies			Difference
Deviation	N	Mean	SD	N	Mean	SD	t-							

Panel B: ½