

The reality of auditing in light of accounting conservatism

واقع التدقيق في ضوء التحفظ المحاسبي

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Received: 09/10/2020; Accepted: 02/12/2020 publication 31/12/2020

Abstract: In response to the contemporary interest in auditing roles, financial reports quality and the issue of accounting conservatism, this research paper aims to reveal the reality of auditing in light of the accounting conservatism where auditing plays the main role through its responsibility in examining the financial reports. we realized this study by representing the most important literature and applied studies that have been subjected to the nature of relationship between these two variables . And through this study, we reached a basic conclusion that accounting conservatism would improve the quality of auditing by improving the quality of financial reports.

Keywords: Accounting conservatism ; audit; financial reports; quality of accounting information.

Résumé : En réponse à l'intérêt contemporain des rôles de d'audit, la qualité des rapports financiers et à la question du conservatisme comptable, ce document vise à révéler la réalité de l'audit à la lumière du conservatisme comptable où l'audit joue un rôle principal à travers sa responsabilité de l'examen des rapports financiers. nous avons réalisé cette étude à travers une présentation des différentes études théoriques et appliquées ayant traité ce sujet . Et grâce à cette étude, nous sommes parvenus à la conclusion fondamentale que le conservatisme comptable peut améliorer la qualité de l'audit en améliorant la qualité de l'information comptable.

Mots-clés : conservatisme comptable; l'audit; rapports financiers ; qualité de l'information comptable .

ملخص: استجابة للاهتمام المعاصر بأدوار المراجعة،

جودة التقارير المالية ومسألة التحفظ المحاسبي، تهدف هذه الورقة البحثية إلى الكشف عن واقع التدقيق في ظل التحفظ المحاسبي حيث يلعب التدقيق الدور الرئيسي من خلال جودة التقارير المالية. و قد حققنا هذه الدراسة من خلال عرض أهم الأدبيات والدراسات التطبيقية التي تعرضت إلى دراسة طبيعة العلاقة بين هذين المتغيرين . وقد توصلنا من خلال هذه الدراسة إلى نتيجة أساسية مفادها أن التحفظ المحاسبي من شأنه أن يحسن من جودة التدقيق من خلال تحسين جودة التقارير والبيانات المالية المقدمة.

الكلمات المفتاحية : التحفظ المحاسبي ، التدقيق ، التقارير المالية ، جودة المعلومة المحاسبية.

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I- Introduction:

We note that beginning with 1995 accounting conservatism aroused a particular interest to researchers. All presented papers point out the presence of accounting conservatism in varying degrees, none of them mentioning its lack. Most often, the topics approached in the accounting conservatism research haven't been exhausted in a single paper, but have been transmitted over years from author to author and from paper to paper. Sometimes, researchers have followed paths which although have proved viable in their study, they haven't been validated by economic reality, a fact signaled by those who subsequently have resumed the respective topics.

In recent years, the focus of accounting studies has been on accounting conservatism considered the most important principle to greatly influence the appropriateness and reality of accounting information included in financial statements. Ball, Kothari & Nikolaev (2009) considers accounting conservatism and timely reporting to be the sources of transparency in financial statements. One of the main purposes of financial statements disclosure is to inform external users about the economic and financial situation of an organization. Specially, after the path-breaking works of Ball and Brown (1968) and Beaver there has been a consensus among the accounting community that financial statement disclosure should help to reduce the information asymmetry existing between internal and external users. Thus, one might assume that information published in financial statements should be both useful and credible.

Preparation of fair financial statements is the responsibility of management, but providing reasonable assurance on the fairness of these financial statements is the responsibility of the auditors, who receive constant support from these managers (clients). Timely loss recognition or conditional conservatism is considered as a determinant of quality of financial statements where auditors have incentives to investigate the quality of financial statements. Conservatism is a valuation principle that requires profits to be reported, not when cash is received, but when the cash flows are verifiable or in other words, payoffs from positive NPV projects are recorded in the future after the recognition of future sales. Hence, conservatism requires timely recognition of losses and requires gains to be recognized when earnings are verifiable.

From these general trends, the problem discussed in this study is exemplified through answering the following questions:

Does Accounting Conservatism impact on audit quality ?

As an initial answer to this question we take the following hypothesis:

There is an impact of the accounting conservatism on audit quality.

I.1. Literature Review

I. 1.1. Auditing

we will start with developed countries known as the countries having thorough audit regime. The passage of the Public Company Accounting Reform and Investor Protection Act (Sarbanes-Oxley) in 2002 provoked a heated discussion. The SOX created the Public Company Accounting Oversight Board (PCAOB) to play a role of monitor and regulator of auditing. Moehrle (2016) has argued that warranting the Financial Accounting Standards Board (FASB) independence is so important. Kozloski, Meckfessel, Moehrle, and Williams (2016) have synthesized the literature about the SOX. Shaw and Terando's (2014) results have suggested that the effect of SOX on audit and audit-related fees is strong. Li's (2009) research has explained one of the reasons that the foreign firms left American market, the high cost conforming to SOX, which is related to audit partner rotation. Kwon, Lim, and Simnett (2014) have confirmed that the implementation of SOX did increase audit fees and audit hours in the post-regulation period (Tim and Xin, 2017, p:267).

Some studies have demonstrated that audit partner rotation always relates to audit opinion shopping (Chow & Rice, 1982). The SOX had a belief that audit rotation could assist in improving the presentation of fairer audit reports, while audit firms had the opposite views. Auditors argued, from their experience of executing audit process, that the loss of audit engagement partner continuity would negatively affect audit quality and the quality of financial statement information due to the loss of client familiarity and an increase in information asymmetry. Furthermore, the audit firms argued that these negative effects would be more pronounced during the initial years of a client partner's client engagement (American Institute of Certified Public Accountants [AICPA], 1992). From the empirical research, Litt, Sharma, Simpson, and Tanyi (2014) collected the digit from 2000 to 2004 to show that the association between audit rotation and the quality of audit opinion is negative. The United States General Accounting Office (GAO) has found the same result. On the opposite, the SOX does improve the quality of audit opinion positively. Lee, Strong, and Zhu (2014) have pointed out that the stricter the regulation is formulated and forced, the fewer mistakes there will be during valuing the price of securities.

In Nagy's (2014) report, the demand of the PCAOB to issue audit firm quality control inspection when the firms performed in a poor quality control system decreased market share of the companies. Other departments of government took some actions to perfect their work. Files (2011) has examined that cooperation with the Securities and Exchange Commission (SEC) staff and forthright disclosure of a restatement (e.g., disclosures reported in a timely and visible manner) could reduce the cost of company. Meanwhile, the cooperation

works in a more efficient and effective way to present fair financial statement and reduce the risk of audit opinion. Besides the enforcement, the setters also pay attention to explaining concept in detail. PCAOB issued AS 3101.20 in 2015 explaining that a qualified opinion assures that the financial statements are fairly presented in all material aspects, with only one part having quality problems. An adverse opinion and a disclaimer of opinion, just the opposite, cannot offer guarantee concerning the financial statements to the investors and other relative beneficiaries (Cipriano, Hamilton, & Vandervelde, 2016). (Tim and Xin, 2017, p:267) .

I. 1.2. Audit quality

From early on, audit quality has been defined as an outcome conditional on the presence of certain attributes of auditors. The widely used definition by DeAngelo (1981, 186) defines audit quality as “the market assessed joint probability that a given auditor will both discover a breach in a client’s accounting system, and report the breach.” This definition is often interpreted to break down audit quality into two components: (1) the likelihood that an auditor discovers existing misstatements and (2) appropriately acts on the discovery. The first component links to an auditor’s competence and level of effort while the latter relates to an auditor’s objectivity, professional skepticism and independence.

These two components also suggest that different 7 As a result several regulators and standard setters seem to have reached the conclusion that arriving at consensus on a definition of audit quality may be impossible. For instance, the Financial Reporting Council (FRC 2006, 16) state “there is no single agreed definition of audit quality that can be used as a ‘standard’ against which actual performance can be assessed.” In the Consultation Report of International Organization of Securities Commissions (IOSCO 2009, 3), a similar sentiment is expressed in that audit quality is difficult to define and is specific to the stakeholder and consensus difficult to achieve. 5 aspects of the audit can influence overall audit quality. The discovery of a misstatement requires that appropriate resources be effectively utilized in the audit process (i.e., inputs and process) while reporting a misstatement requires an auditor to take appropriate action given the current context at the end of the audit (i.e., output and context). The following problems arise from this definition, however: (1) it has not been reconciled with the audit risk model which is used to guide the audit and reflects the auditor’s perceptions and (2) the perception of market participants can be erroneous. Despite this limitation, the DeAngelo (1981) definition of audit quality identifies two important components of audit quality (Knechel, Krishnan, 2012, p:04) .

In summary, there is currently no unified definition of audit quality. As a result, developing a framework may be the best alternative to gauge overall audit quality.

I.1.3. Accounting conservatism definition

The concept of conservatism in accounting practices has remained a predominant characteristic of the accounting field for several centuries , however standard setters and accountants have heavily criticized the concept of conservatism .Conservatism is defined as the differential verifiability required for recognition of profits versus losses. In its extreme form the definition incorporates the traditional conservatism adage:"anticipate no profit, but anticipate all losses." Despite criticism from many quarters including standard-setters, conservatism appears not only to have survived in accounting for many centuries, but also to have increased in the last 30 years (Watts , 2002 , p:01) .

The occurrence of accounting conservatism lies in the early years of trade relations ,«Sudiptu Basu» shows that there is evidence that ever since the fifteenth century , there have been practices of accounting conservatism in commercial partnerships(Neag and Masca , 2015 , p: 1115) .

Accounting conservatism is one of the four accounting conventions, which are standards, customs or guidelines regarding the application of accounting rules, it is a set of bookkeeping guidelines that call for a high degree of verification before a company can make a legal claim to any profit. In 1939 « Stephen Gilman » and « Kenneth Macneal » discuss in their papers the question of asset valuation bases presented in the financial reports , on whom they disagreed «Stephen» holds up the necessity of using historical cost and «Kennith» states that the assets should be presented at current market value as of the date of the statement .Stephen Gilman considers that it must not take into account the common accounting convention according to whom assets should be stated at the lower of cost or market values and appreciates this accounting practice as "distorting and unconservative". He doesn't see the meaning of asset revaluation and proposes the return of the original cost. On the other hand, «Kenneth MacNeal» considers that balance sheets must disclose important information, namely they shall present the assets at their current market value and he presents several methods of determining it. At that time, Stephen Gilman's attitude was appreciated to be viable, it was considered that «Kenneth MacNeal» was doing nothing else than provoking controversy.

«Feltham» and «Ohlson» , 1995 defined accounting conservatism as the persistence in underestimating the book value of the firm, implying that book value is less than market value. Essentially in this paper, «Gerald A . Feltham» and «James A. Ohlson» , 1995 analyse the relationship between accrual accounting and valuation of a firm's equity and goodwill. The authors define several concepts, including operating activity, market value ,book value abnormal earnings, goodwill firm's equity. They begin by treating operating and financial activities in terms of firm's market value and accounting date in (Neag and Masca , 2015 , p: 1116) .

the statement of financial accounting concept 1980 developed by financial accounting statements board , conservatism is defined as a prudent reaction to uncertainty to try to ensure that uncertainties and risks inherent in business situations are adequately considered .

The general concept of accounting conservatism is to factor in the worst-case scenario of a firm's financial future. Uncertain liabilities are to be recognized as soon as they are discovered. In contrast, revenues can only be recorded when cash exchanges hands.

I.1.4. Type of accounting conservatism

Some accounting researchers differentiate between two types of accounting conservatism: conditional conservatism, defined as the higher degree of verification needed for good news than for bad news; and unconditional conservatism, which refers to early recognition of losses independent of the news. Although both forms of conservatism tend to reduce income and equity, they are not merely substitutes for each other , (because conditional conservatism arises from efficient debt and governance contracting and increases the contracting efficiency of accounting information. Unconditional conservatism, on the other hand, arises from tax, litigation and managerial self-interest, and is likely to reduce the contracting efficiency of financial reports (Rodriguez, 2010, p: 131) .

I.1.5. Accounting conservatism importance

Accounting conservatism is one of the most important properties of financial statement reporting, conservatism is a limiting principle of accounting that plays the key role of confining the optimistic behaviors of the managers as the ones who provide the information, on the one hand, and providing an estimation of the minimal earnings of shareholders and creditors as the major consumers of the information, on the other. Financial statement reporting as well as the accounting system play critical roles in the finance market. Investors and consumers predict the future performance of a given company as a means to assign values to these companies. Ray Ball, S.P. Kothari and Ashok Robin, 1999 show that since accounting conservatism is higher in the common-law-based countries, in the states with this accounting regime, earnings management is more difficult to be done than in the code-law-based countries. In the common-law-based countries, sensitivity to economic loss is more pronounced than in the code-law-based countries. This high level of sensitivity to economic loss , determines managers' incentives also high, leading to closer monitoring of managers by security analysts .

Therefore, the pressure on managers who benefit incentives is higher in the common-law-based countries, which determined the development, in these countries, of accounting rules sets with a higher level of accounting conservatism.

On the other part Theory indicates that accounting conservatism is important to establish an efficient corporate governance system. The case study of Ericsson supports the theoretical evidence, albeit the sample is small. An

important aspect is that new accounting standards have recently been introduced and we do not know what effect they will have. According to the European standard-setters IASB, the unquestionable purpose of accounting is to give fair presentation of information in order to help users to make economic decisions under several well-established accounting conventions such as going concern, matching, and prudence.(Sward , Rosencratz and Narayanan 2005 , p: 12) .

I.1.6. The conservatism Mechanisms

Conservatism Principle is a concept in accounting under GAAP which recognizes and records expenses and liabilities-certain or uncertain in nature, as soon as possible but recognizes revenues and assets when they are assured of being received. It gives a clear guidance in recording cases of uncertainty and estimates. The principle of Conservatism is one of the major accounting principles and guidelines listed under UK GAAP, which is a regulatory body of principles and standards of accounting that all accountants across the globe need to follow while reporting financial activity of the business. The principle of Conservatism is mostly concerned with the reliability of the financial statements of a business entity.

To explain more clearly the conservatism principle let's assume that a company has an inventory with a cost of \$15,000. However, the marketplace has changed dramatically and now the inventory can be sold for only \$14,000 if the company spends an additional \$2,000 to package and ship the goods. For the next balance sheet the accountant is faced with:

(1) continuing to report the inventory at its cost of \$15,000	Or	(2) to report the inventory at its net realizable value (NRV) of \$12,000
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(NRV is equal to the estimated sales value of \$14,000 minus \$2,000 of expenses necessary to get the \$14,000.) Expressed another way, on the next income statement the accountant is faced with:

(1) ignoring the loss in inventory value until the goods are actually sold	Or	(2) reporting the loss immediately
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The concept of conservatism directs the accountant to 1) report the inventory at the lower NRV of \$12,000 and 2) to report immediately a lower net income due to the inventory write down \$3,000 on its income statement. (The \$3,000 loss is the write down from the cost of \$15,000 to the NRV of \$12,000) .

The conservatism principle does not say that accountants are to be super conservative accountants should be fair and objective. The conservatism principle says if there is doubt between two alternatives, the accountant should opt for the one that reports a lesser asset amount or a greater liability amount, and a lesser amount of net income.

I.2. Accounting Conservatism and Audit quality: the relationship

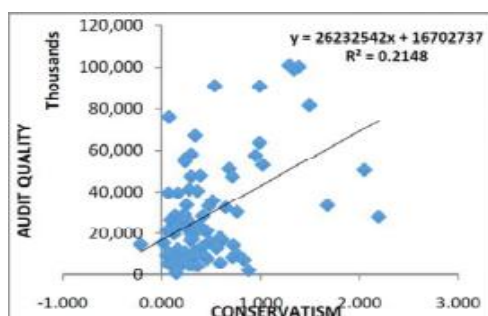
The relationship between audit quality and accounting conservatism has become the subject of an active field of empirical research in accounting , to determine the nature of relationship between both of this variables we based on previous study presented by Sana Ramzan .

The author collected data from 84 publicly and privately companies in the United States , the data were collected for four years differently (2014,2015,2016,2017) , and the relationship was analyzed separately for an unbiased conclusion .

To analyze the relationship of accounting conservatism on audit quality, regression analysis is used by Sana Ramazan as a statistical modelling technique to study the extent of the variation that can be explained by conservatism (independent variable) on audit quality (dependent variable) . The relationship between these two variables, audit quality and accounting conservatism, was examined for each year discretely . Scatter plots were used to analyze and visualize the relationship between the two variables (Ramzan, 2019, p:03) . Regression analysis is a powerful statistical method that allows you to examine the relationship between two or more variables of interest. it allows market researchers to analyze relationships between one independent and one dependent variable.

The model of 2014 successfully proves that accounting conservatism affects audit quality and has a positive association.

Figure (01) : Scatter plot for the relationship between conservatism and audit quality (2014)

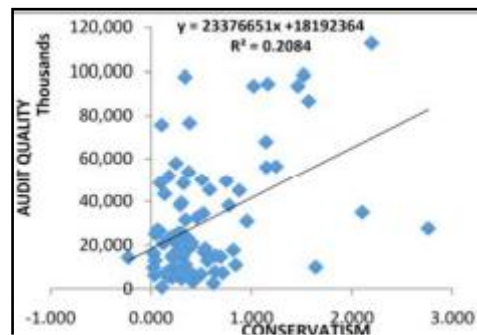


Source: Sana Ramzan , accounting conservatism and audit quality ,conference paper ,April 2019 ,p:03 .

The correlation coefficient between the two variables of 2014 is 46.35%, which proves to be a not so weak relationship. R^2 of the model for 2014 states that %21.47 of the variation in audit quality is explained by accounting conservatism, as shown in Fig.1. Since the significance F is less than 5%, the results obtained are statistically significant (Ramzan, 2019, p:03).

The model of 2015 successfully proves that accounting conservatism affects audit quality and has a positive association.

Figure (02) : Scatter plot for the relationship between conservatism and audit quality (2015)

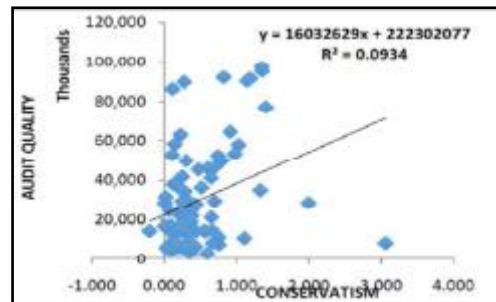


Source: Sana Raman , accounting conservatism and audit quality ,conference paper ,April 2019 ,p:03 .

The correlation coefficient between the two variables of 2015 is 45.65%, which proves to be a not so weak relationship. R^2 of the model for 2015 states that %20.84 of the variation in audit quality is explained by accounting conservatism, as shown in Fig. 2. Since the significance F is less than 5%, the results obtained are statistically significant (Ramzan, 2019, p:04).

The model of 2016 successfully proves that accounting conservatism affects audit quality and has a positive association.

Figure (01) : Scatter plot for the relationship between conservatism and audit quality (2016)

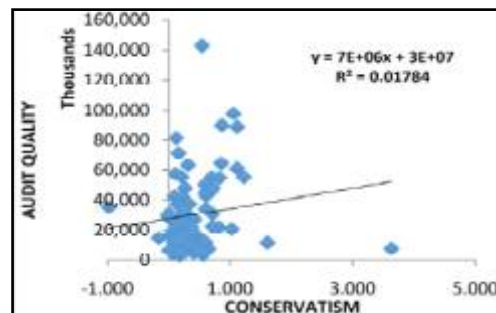


Source: Sana Raman , accounting conservatism and audit quality ,conferencepaper ,April 2019 ,p:03 .

The correlation coefficient between the two variables of 2016 is 30.57%, which proves to be a weak relationship. R^2 of the model for 2016 states that 9.34% of the variation in audit quality is explained by accounting conservatism, as shown in Fig.3. This shows that other determinants should be considered when determining the variation in audit quality. Since the significance F is less than 5%, the results obtained are statistically significant (Ramzan, 2019, p:04)

The model of 2017 successfully proves that accounting conservatism affects audit quality and has a positive association.

Figure (01) : Scatter plot for the relationship between conservatism and audit quality (2017)



Source: Sana Raman , accounting conservatism and audit quality ,conferencepaper ,April 2019 ,p:03 .

The correlation coefficient between the two variables of 2017 is 13.35%, which proves to be a weak relationship. R^2 of the model for 2017 states that only 1.78% of the variation in audit quality is explained by accounting conservatism, as shown in Fig. 4. This may be due to other determinants that have an effect on audit quality. Since the significance F is more than 5%, the model should

incorporate other independent variables for better association and explanation (Ramzan, 2019, p:04) .

After analyzing the four scatterplots, it was noticed that the relationship between audit quality and accounting conservatism is positive in all four years . the results sufficiently prove the arguments which states that higher conservatism leads to higher audit quality.

Also, Xueyan Jia finds in his study titled « The effect of conservatism on audit fees and audit quality » , that the relationships between conditional conservatism and audit quality and between unconditional conservatism and audit quality are contrary to each other. The implementation of conditional conservatism suppresses audit quality, while unconditional conservatism plays a key role in boosting audit quality. Several conjectures about why this counter results exist are mentioned ,but more investigations about this topic are required to determine which kind of conjecture can truly elucidate this inconsistency (Jia , 2018 , p:34) .

Nishtiman , Kunon and Amran tried in their study to examine the impact of audit quality on accounting conservatism in Turkey. Using three different measures of accounting conservatism they report that audit quality, in terms of brand name auditor and industry specialist auditor, is positively related to conservatism. their results hold after controlling for operating cash flow, leverage, firm age and sales growth .Overall, the evidence is consistent that accounting conservatism complements firms in the Turkish business environment that engage with high quality auditors to mitigate agency costs.

Rezaee explains that the motive of Sarbanes-Oxley Act (SOX) 2002 after accounting scandals was to establish a regulatory framework for auditors and accountants that creates more accountability increases penalties for violations , improves corporate governance and increases quality and credibility of financial reports and audit procedures. Because of SOX principle, conservatism and conservative auditing became crucial after various accounting scandals to increase investor confidence in financial markets . and claim that financial scandals are less likely to occur in the future as auditors' procedures are constantly changing to reduce misstatements and any other future financial scandals (Rezaee, 2005, p:13)

Taylor , Harrison and Dezoort justify that due to greater levels of accountability and increase in accountability pressures, auditors need to exhibit increased levels of conservatism which determines lower materiality thresholds. This is due to the contracting explanation (Taylor Harrison, Dezoort, 2006, p:45)

II– Methods and Materials:

The approach used in this study is an iterative review of the literature and publications relevant to both of accounting conservatism and audit quality. This study reviews also some previous empirical studies and publications which determine and examine the relationship between accounting conservatism and audit quality.

III- Results and discussion :

we draw from the study Above the following results:

- Accounting conservatism represents one of the significant features of the quality of financial information, the quality of the information provided in financial statements is an integral attribute that affects the decisions taken by an investor regarding a particular investment. Higher audit quality leads to better decisions by investors, and this is possible if managers and auditors are conservative.
- Increase in conservatism increases audit quality, which thus leads to efficient investments as accounting conservatism creates an informed capital market that delivers conservative financial statements constituting verifiable financial numbers . argue that conservative statements with reassurance from auditors improve investor decisions , which determines that the quality of the audit was high .
- Accounting conservatism is one of the most important accounting principles that accountants still insist on it , and we can conclude that accounting conservatism impacts the audit quality because it is limited to manipulate accounting information then it can help to improve the quality of financial reports .

IV-Conclusion:

One of the main purposes of financial statements disclosure is to inform external users about the economic and financial situation of an organization .Specially, after the path-breaking works of Ball and Brown (1968) and Beaver there has been a consensus among the accounting community that financial statement disclosure should help to reduce the information asymmetry existing between internal and external users.

Finally, we can suggest as future research a larger sample of firms with corporate legal structures, such as private companies or limited liability companies. Other attributes of audit quality can also be investigated, or even the quality of accounting information such as earnings management, value relevance etc. Statistical estimates would also be relevant to determine more adequately the parameters of the models in research that deals with the auditing. Also, use of other methods of data collection, such as questionnaires and interviews with

analysts, auditors and professionals involved with the audit work could be used to verify that these professionals contribute to better quality of information.

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