**Conservatism and Endogenous Preferences**

Abstract

Literature suggests that individuals have endogenous preferences for accounting conservatism due to intrinsic loss aversion. However, no empirical evidence for this claim exists. This paper provides first experimental insights on individuals’ endogenous preferences for conservative compared to neutral accounting. Preliminary findings suggest that in a judgment context based on innate loss aversion, individuals experience higher utility from conservatism and value conservatism more highly than neutrality in accounting. We further investigate if individuals also show explicit preferences for conservative vs. neutral accounting by implementing a choice setting. Preliminary results provide evidence that individuals do not prefer conservative over neutral accounting when presented with both options. The study contributes to the ongoing discussion on accounting conservatism by establishing that a disregard for peoples’ endogenous preferences for conservatism associated with neutral accounting can have detrimental economic consequences, such as a lower willingness to invest.

**Keywords:** Accounting Conservatism, Endogenous Preferences, Loss Aversion, Prospect Theory

In this study, we investigate whether investors have endogenous preferences for conservatism compared to neutrality in accounting due to intrinsic loss aversion. Prior literature argues that conservative accounting is a prudent reaction to uncertainty demanded by the firm’s stakeholders (Watts, 2003). Recent literature reasons that individuals have endogenous preferences for conservatism in accounting (Nagar et al., 2014; Hirshleifer and Teoh, 2009). Accounting conservatism is characterized by demanding higher verification requirements for gains than losses (Watts, 2003), resulting in a more timely recognition of losses than gains (Basu, 1997). Future losses are anticipated when they are probable, whereas future gains are only recognized when realized. By considering potential future losses up-front, users of accounting information are protected from future disappointment, thereby addressing individuals’ intrinsic loss aversion (Hirshleifer and Teoh, 2009). In this study, we investigate individuals’ endogenous preferences for conservatism and the consequences of a possible mismatch between accounting methods and investors’ preferences. Based on loss aversion (Kahneman and Tversky, 1979), we expect that conservatism results in investors evaluating a firm’s performance more favorably relative to neutral, that is, non-conservative accounting.

Although being a fundamental accounting concept, conservatism has increasingly become a controversial issue. Literature provides evidence that the asymmetric treatment of gains and losses is beneficial for debt-holders due to increased contract efficiency (Kothari et al., 2010), as well as for equity holders due to constraining earnings management and thereby providing more reliable information to users (García Lara et al., 2014; Francis et al., 2013). However, opponents find that conservatism results in biased information, concealing true performance. In recent years, standard setters have followed this critical view and currently give preference to neutral accounting (IASB Conceptual Framework for Financial Reporting 2010 and ED/2015/3) with the objective of providing accounting information that is more useful to users, leading to a symmetric treatment of gains and losses

Until recently, conservatism has mostly been examined from an agency-theoretic or decision usefulness perspective. Nagar et al. (2014) analyze conservatism from an evolutionary point of view and argue that conservatism originated from humans’ psychological bias of intrinsic loss aversion that developed through human evolution. Research has found that even very young children (Harbaugh et al., 2001) as well as primates (Chen et al., 2006) show loss aversion. This bias is considered to be deeply rooted in human beings and seems to be rather innate than learned (Chen et al., 2006). Hence, if loss aversion is innate, people are not necessarily aware of being biased by this phenomenon. As a consequence, users of accounting information who dislike being disappointed thus may find conservatism attractive without being aware of the fact and the reason for it (Hirshleifer and Teoh, 2009).

In this study, we use the case of the accounting for research and development (R&D) expenditures as an example for variants of different degrees of conservatism. Immediate expensing of R&D as incurred is a typical example for conservative accounting (Beaver and Ryan, 2005). Capitalizing R&D expenditures, on the other hand, represents neutral accounting by symmetrically matching the investment outlay with the future benefits derived from the investment.[[1]](#footnote-1) Other examples of conservative accounting, among others, would be the accounting for provisions or the impairment of assets.

Rationally, applying conservative or neutral accounting does not make a difference in overall results, but it influences the timing of loss recognition. Hence, in the short-run, conservatism and neutrality frame a situation differently. The immediate expensing of R&D expenditures separates the initial investment from future project outcomes. Thus, in a conservative setting, individuals do not face a loss in later periods when the project is unsuccessful. Because potential losses are anticipated, future disappointments are avoided. In contrast, in the neutral setting there is no negative impact on profits at inception, but a loss in later periods when the potential loss is realized. The neutral setting thus creates disappointment that is avoided in the conservative setting.

Literature provides strong evidence that, due to limited cognitive capacity, individuals process information in the form in which it is presented (Payne, 1982). Framing, i.e. presenting the same concept or situation differently, can impact users’ judgments (e.g. Levin et al., 1998; Kühberger, 1998; Tversky and Kahneman, 1981). According to prospect theory (Kahneman and Tversky, 1979), individuals are hurt by losses more strongly than they are thrilled by gains relative to the relevant reference point. Losing a certain amount of money nearly hurts twice as much as gaining the same amount of money provides pleasure (Tversky and Kahneman, 1992; Kahneman and Tversky, 1991). If conservatism helps in avoiding such loss experiences, individuals should show a preference for conservative accounting. We provide a novel experiment to investigate if (1) individuals have such preferences and if (2) they actively prefer to invest in firms that apply conservative accounting.

In a first step, we examine if investors have unconscious endogenous preferences for conservatism over neutrality in accounting by investigating if they experience higher utility in a setting of conservative relative to a neutral accounting in a between subjects design. In the next step, we switch to a within-subjects design to additionally analyze if investors also consciously prefer conservative over neutral accounting in a deliberate choice setting. Combining a between- with a within-subjects design is one method to shed more light on subjects’ unintentional biases, which corresponds to what we call ‘unconscious’ preferences in our setting, and subjects’ intentional judgments, which we call ‘conscious’ preferences in our study (Kahneman and Tversky, 1996; Libby et al., 2002).

In the experiment, subjects assume an investor role. We endow them with an equity stake in a company that they are subsequently allowed to hold or sell at any time. The company conducts R&D projects that influence its future performance (equity) and hence also the value of subjects’ equity stake. We use a 2x2 between-subjects design which manipulates the accounting method applied for R&D expenditures (neutral vs. conservative accounting) as well as R&D projects’ outcome (success vs. failure). R&D expenditures are either capitalized or expensed and the probability of R&D project success or failure is 0.5 respectively. Subjects are randomly distributed to one treatment group. We operationalize unconscious endogenous preferences by asking subjects about their happiness in each time period of the project investment. Furthermore, we elicit subjects’ evaluation of firm performance by implementing a second price auction procedure adapted from Becker, DeGroot, Marschak (1964), measuring subjects’ willingness to accept (WTA). By comparing investors’ WTA across treatments we evaluate their differential willingness to invest in the firm. To examine if individuals also show explicit conscious preferences for conservatism relative to neutrality in accounting, we switch to a within-subjects design and let subjects make investment choices between both accounting methods. Subjects’ deliberate choices between conservative and neutral investment options offered in a choice setting provide us with data regarding individuals’ explicit conscious preferences for one or the other accounting method.

We are currently in the process of conducting the final experiment and analyzing our data. The results based on the pretest support our expectations: Individuals show unconscious preferences for conservative relative to neutral accounting and display a significantly lower willingness to accept for the neutral condition, that is, investors sell their equity stake prematurely. In deed, subjects are willing to sell their shares at prices below their economic value only under neutral accounting after having experienced losses. The results are consistent with the interpretation that loss aversion causes investors to have a lower willingness to invest in the neutral accounting condition.

Our study addresses the call for more research on “whether and when people have an irrational preference for conservative reporting” (Hirshleifer and Teoh, 2009: 1075). While several rational explanations for conservatism have been proposed (e.g. Watts, 2003), psychological bias has not yet been analyzed. Our study addresses this gap in the literature by providing first experimental evidence for investors’ endogenous preferences for conservative relative to neutral accounting. From a manager’s or company’s point of view it can often be economically more efficient to defer losses to the future due to discounting effects. To the contrary, from an investor’s point of view, considering losses up-front better addresses individuals’ intrinsic loss aversion. The study contributes to the ongoing discussion on conservative vs. neutral accounting by highlighting that disregarding peoples’ endogenous preferences for conservatism can have economic consequences, such as investors’ lower willingness to invest in firms applying neutral accounting.

We also contribute to the literature on R&D accounting. There is an ongoing debate about the usefulness of capitalizing intangible investments. For example, individuals’ judgment performance is shown to be more accurate in the capitalizing than in the expense condition (Luft and Shields, 2001). Our study suggests that from an individual’s endogenous preference perspective expensing may outweigh capitalizing R&D when considering individuals’ investment decisions.

1. We only consider these technically opposite methods of accounting as representative for conservatism and neutral accounting and do not take into account discretion involved in the application of a particular accounting standard (e.g. IAS 38). [↑](#footnote-ref-1)