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APPLICATION OF THE PRINCIPLE OF CONSERVATISM AGAINST THE APPLICATION OF THE FAIR VALUE CONCEPT – AN EXAMPLE OF THE SERBIAN CAPITAL MARKET

Abstract

The characteristic of striving towards the application of the new valuation concept, as opposed to the application of traditional accounting principles, modern financial reporting prompted the authors of this paper to address the importance of the application of traditional accounting principles, especially the principle of prudence (conservatism), and the concept of fair value for the accounting information relevance. The most important business decisions in the entity are made on the basis of information produced by the accounting information system, based on which we see how important it is for this information to be up to date. The relevance of the information of the accounting system of first-class importance is the basis of evaluation, which is the subject of research in this paper. More precisely, the paper examines the methods of measurement after initial recognition of fixed assets on the example of a group of business entities operating on the Serbian capital market. The results of empirical research are of a twofold nature. Namely, for measurement after initial recognition of intangible assets, plant and equipment, as well as other property, plant and equipment, the concept of historical cost and the traditional accounting principles immanent to it are primarily used. For measurement after initial recognition of buildings, land, investment property and biological assets, the concept of fair value is more often used. In other words, using a practical example, we have shown that the combined basis of financial reporting is the dominant feature of modern financial reporting of entities operating in the Serbian capital market.

Key words: traditional principle of prudence (conservatism), valuation concepts, Serbian capital market, fixed assets

JEL classification: M41, M42

ПРИМЕНА ПРИНЦИПА КОНЗЕРВАТИВИЗМА НАСУПРОТ ПРИМЕНИ КОНЦЕПТА ФЕР ВРЕДНОСТИ - ПРИМЕР СРПСКОГ ТРЖИШТА КАПИТАЛА

Апстракт

Карактеристика тежње ка примени новог концепта вредновања, насупрот примени традиционалних рачуноводствених принципа, савременог финансијског извештавања нагнала је ауторе овог рада да се позабаве

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питањем значаја примене поменутих традиционаlnih рачуноводствених принципа, пре свега принципа опрезности (конзервативизма), и концепта фер вредности по релевантност рачуноводствених информација. Најбитније пословне одлуке у ентитету доносе се на бази информација које продукује рачуноводствени информациони систем, на основу чега видимо колико је битно да те информације буду ажурне. На релевантост информација рачуноводственог система од прворазредног значаја је примењена основа вредновања која представља предмет истраживања овог рада. Прецизније, овај рад се бави испитивањем примењених метода накнадног вредновања сталне имовине на примеру групе пословних ентитета који послују на српском тржишту капитала. Резултати емпиријског истраживања двојаке су природе. Наиме, за накнадно вредновање нематеријалне имовине, постројења и опреме, као и осталих некретнина, постројења и опреме, превасходно се користи концепт историјског трошка и њему иманентни традиционални рачуноводствени принципи. За накнадно вредновање грађевинских објеката, земљишта, инвестиционих некретнина и биолошких средстава, чешће се користи концепт фер вредности. Другим речима, на практичном примеру утврђено је да комбинована основа финансијског извештавања представља доминантну карактеристику савременог финансијског извештавања ентитета који послују на српском тржишту капитала.

Кључне речи: *традиционални принцип опрезности (конзервативизма), основе вредновања, српско тржиште капитала, стална имовина*

Introduction

The principle of prudence (conservatism) has long been considered as one of the most important accounting principles. It belongs to the group of traditionally applied accounting principles aimed at reducing the risk of overestimation of results, which directly contributes to the long-term survival, growth and development of the entity's business. However, regardless of its undoubted benefits for business stability, it is criticized for the insufficient relevance of the information produced. Namely, in modern business, there is a need to determine the real value of entities' net assets at a given time. This is benefit to modern financial reporting that the concept of fair value provides. That everything has its price is shown by the fact that the relevance of information produced by the concept of fair value is compromised due to insufficient reliability and verifiability of this information.

Business communication between the entities and a number of stakeholders takes place through financial statements that are published as part of the annual report. The conducted research is based on accounting data published in the individual financial statements of the entities from the Belgrade Stock Exchange for a period of three years (2016-2018). Our sample includes entities whose securities are listed on the Prime Listing, Standard Listing and Open Market. Our research aims to determine the attitude of entities that list their securities on the Serbian capital market (Belgrade Stock Exchange) towards the application of the principle of conservatism under the concept of historical

cost versus the application of the fair value concept for valuation of fixed assets.

Theoretical background

Some theorists believe that the emergence of accounting conservatism is associated with the first years of trade relations. For example, Watts (2003) believes that the very basis of accounting is the contractual relationship between two stakeholders and that this fact in itself indicates the need for conservatism. The principle of conservatism is an essential accounting construction that can be described as a pervasive concept of accounting valuation (Sterling, 1967). In other words, this principle implies the choice of accounting policies that determine the most appropriate terms and amounts of recognition of the effects of certain business transactions in order to “avoid artificial hypertrophy of net assets and net profit when these amounts are uncertain” (Savić, 2014, p. 29-30).

The principle of conservatism represents a complex whole of four interconnected principles: the principle of realization, the imparity principle, the principle of lower value and the principle of higher value. The principle of realization helps cover income that actually arose in the accounting period (i.e. income from realized products and services) and ensures that the impact of production results that are not realized on the market is made neutral in terms of financial result. The imparity principle recognizes as realized the expected negative contributions to success, i.e. losses from unrealized, but actual business activities and allows their inclusion in the income statement together with realized expenses and income. In other words, future positive and negative contributions to success are treated unequally, i.e. unrealized gains are viewed from the aspect of the realization principle and unrealized losses from the aspect of the imparity principle, which in this domain limits the principle of realization. The lower value principle is the requirement that assets be valued on the basis of the purchase price (cost price), only provided that the purchase price (cost price) is not higher than the current market price, while the higher value principle is the requirement to balance liabilities at a higher value between nominal values and effective values.

Hidden reserves, as a manifestation of the principle of conservatism, are most often created by “underestimating assets items, but also by overestimating liabilities items, with the aim of creating a certain degree of protection against numerous business risks” (Savić, 2014, p. 33). Uncertainty is immanent to modern business. In this regard, investors are interested in applying conservatism as a way to monitor bad news in a timely manner (Arsenijević, 2020b, p. 376). Shareholders and future investors “use information from financial statements to make strategic decisions regarding the purchase and sale of shares, which have a direct impact on the market price of shares” (Georgescu, Pavaloaia, & Robu, 2014, p. 828). Untimely disclosure of “bad news” reduces the quality of information directed at the users of financial statements, which can potentially result in a significant reduction in the market price of shares when the data is published after a certain period of time. Greater business uncertainty leads to more conservative reporting (Hsieh, Ma & Novoselov, 2019, 41) and affects the need to control the activities of managers. In this matter, accounting conservatism helps investors and other interest groups (Hsieh, Ma & Novoselov, 2019, 44). “In order to make rational decisions, it is necessary to present the effects of past transactions through general purpose financial reports not only on a neutral basis, but also on the basis of careful measurement of net assets” (Denčić-Mihajlov, Krstić & Spasić, 2016, p. 641).

Standard setters, on the one hand, and theorists and practitioners, on the other, have differing views on the need of applying accounting conservatism. Standard setters believe that the principle of conservatism does not adequately reflect the business risk and therefore promote the concept of fair value in the new IFRS and revised IAS. The knowledge of market opportunities, which in the form of anticipated financial data provides the concept of fair value, contributes to the appropriation of anticipated profits (Richard, 2015, 24). However, numerous studies show that theorists and practitioners still see this principle as a basic characteristic of financial reporting (Arsenijević, 2020b, 376). In other words, emphasizing the futuristic character of the accounting system and the information it produces aims to fulfill the wishes of ambitious shareholders in terms of very high profits and dividends that should be realized as soon as possible.

Observing the relevance of information from the market aspect has influenced the further development of accounting theory and its orientation towards the concept of fair value (Hitz, 2007). We are of the opinion that it is expedient to emphasize the existence of a difference between the use of fair value and the concept of fair value (Škarić-Jovanović, 2015b, p. 329-330). Specifically, it is common to use fair value in both the initial and measurement after initial recognition of certain forms of assets within the concept of historical cost. Within the concept of historical cost, market value is treated as a type of fair value, so the assets acquired through exchange are initially valued at fair value, while in the case of measurement after initial recognition, assets are valued at a lower value between book and market value at the reporting date. Unlike the historical cost concept, the fair value concept is based on the assumption of continuous application of fair value for valuation of assets and liabilities and on the assumption of the result as the difference between the fair value of net assets stated at the end and beginning of the reporting period in the balance sheet. Continued use of fair value implies its initial and ex-post use for the purpose of valuing assets and liabilities, regardless of whether the carrying amount of assets and liabilities is higher or lower than fair value. The last determined fair value is taken as the book value of assets, and if it is a fixed asset, then the book value is obtained when the last fair value is reduced by systematic write-offs made in the reporting period. The financial result of operations presented "simply as a change in the fair value of assets and liabilities presented in the balance sheet" (Škarić-Jovanović, 2009, 422) between the two reporting periods is the goal of financial reporting according to the concept of fair value.

By reading and analyzing financial statements, a wide range of stakeholders can gain insight into the economic history of the entity and profile its future performance expressed in terms of future earnings levels and cash flow dynamics. The quality of the information presented in the financial statements is best reflected in the assessment of the fulfillment of requirements regarding their qualitative characteristics. The conceptual framework of financial reporting divides all qualitative characteristics of information into two groups: 1) fundamental characteristics and 2) improving characteristics. The first group consists of relevance and faithful representation, while the second group includes comparability, verifiability, timeliness and understandability. On this occasion, we will pay more attention to the characteristic of information relevance. Relevant financial information is information that may lead to differences in the decisions of users of financial statements and which may perform the function of predicting future results or the function of confirming and assessing the effects of past events or both. Therefore,

“predictability and reversibility are cited as secondary elements of relevant information” (Đukić & Pavlović, 2014, p. 107). “Whether financial information will be relevant or not depends primarily on its nature and importance, which actually means that if it is omitted or misinterpreted, it can in some way affect the business decision maker” (Lalević-Filipović & Lakićević, 2011, p. 73). However, the Conceptual Framework largely neglects the qualitative characteristic of information reliability. The reason for this is the change in the purpose of the preparation of accounting information, which is now directed towards the faithful representation of relevant financial information. When it is applied to the whole of the assets and liabilities of the entities from period to period, concept of fair value ensures the realization of the mentioned goal (Arsenijević, 2020b, p. 380).

Methodology

The central institution of the Serbian capital market is the Belgrade Stock Exchange. According to the Rules of Procedure of the Belgrade Stock Exchange a.d. Belgrade, the stock exchange organizes and manages a regulated market and a multilateral trading platform (MTP Belex). There are three segments of the regulated market on the Belgrade Stock Exchange (Prime Listing, Standard Listing and SMart Listing) and one non-listing segment – Open Market (Rules of Procedure of the Belgrade Stock Exchange, Article 58). Securities included in the regulated market and MTP are grouped according to certain criteria, types of securities, trading methods, phases and duration of trading phases, as well as other market elements (Rules of Procedure of the Belgrade Stock Exchange, Article 60).

Data collection for the purposes of this research is based on a sample method whose representativeness is ensured by taking into account the nature of the problem, the purpose of the research and the available data collection options. The conducted research (Arsenijević, 2020a, p. 224-277) is based on accounting data published in the individual financial reports of the entities from the Belgrade Stock Exchange for a period of three years (2016-2018). Our research was performed on a sample of 27 entities whose securities are listed on the regulated market of the Belgrade Stock Exchange. The total sample of entities according to the segment of the regulated market has the following structure: 4 entities (15% of the sample) are listed on the Prime Listing, 3 entities (11% of the sample) on the Standard Listing, while securities of 20 entities (74% of the sample) are listed on the Open Market. The research was conducted by collecting and arranging data on the application of the concept of historical cost and the concept of fair value for the valuation of fixed assets. Given the well-known fact that fixed assets represent a significant item of total assets in almost all business entities, the consequences of valuing assets at fair value can best be seen in this group of assets.

The following part of the paper focus on the determination of tangible, intangible and financial items of fixed assets that are valued, first, by the concept of historical cost (in accordance with the principle of conservatism) and, secondly, by the concept of fair value, all in order to determine the prevailing asset valuation concept of entities listed on the regulated market of the Belgrade Stock Exchange.

Research results and Discussion

Of the 27 entities in the sample, 23 entities published detailed data on the structure of fixed assets, on the basis of which an analysis of individual subgroups within this asset group was performed. The material form of fixed assets consists of land, buildings, plant and equipment, investment property, biological assets and other tangible assets. These items have different effects on the total value of fixed assets according to their share in total fixed assets. Intangible form of fixed assets is an increasingly important asset component in modern entities. It consists of: investment in development, concessions, patents, licenses, software and other rights, goodwill and other intangible assets. Due to the insufficient importance of intangible assets in our entities, as well as the insufficient legal regulation of this area in our country, it cannot be said that the previous statement is valid for Serbian entities included in the sample.

I) Information on the application of the historical cost concept or the fair value concept for the valuation of fixed assets is not in itself sufficient. It is necessary to know the share of an individual item in the total fixed assets in order to determine the level of impact that a particular item has on the total value of fixed assets and thus on the value of the entire assets of the entity. Given that the range of share of certain types of fixed assets is from 0% in some entities to 100% in other entities, we believe that it is appropriate not to attach importance to the extreme values of the data set in order to draw correct conclusions at the sample level. The measure of the central tendency that enables us to observe a large series of data, while excluding the extreme values of the observed data, is the median. The median shows the percentage that is in the middle of a series of data sorted by size.

The following table presents the absolute and relative number of entities in the sample that value a) plant and equipment, b) other property, plant and equipment, and c) intangible assets at historical cost or fair value.

Table 1: Measurement after initial recognition of a) plant and equipment, b) other property, plant and equipment and c) intangible assets

Basis of measurement	A) Plant and equipment		B) Other real estate, plant and equipment		C) Intangible assets	
	Number of entities	% of entities	Number of entities	% of entities	Number of entities	% of entities
Historical cost	18	67%	12	44%	21	78%
Fair value	9	33%	8	30%	2	7%
Not disclosed	0	0%	4	15%	0	0%
Entity does not have this type of assets	0	0%	3	11%	4	15%
Total	27	100%	27	100%	27	100%

Source: Arsenijević, 2020a, p. 244-259.

The table shows that the concept of historical cost is used for measurement after initial recognition of plant and equipment (A) in 67% of the sampled entities that disclosed data on the structure of fixed assets, and that the concept of fair value is used in 33%. Also, the table indicates a lower percentage of entities using the historical cost concept to value (B) other property, plant and equipment (44%) and almost the same percentage of entities applying the fair value concept (30%) compared to the previous item of tangible assets. When we include in the analysis the share of these tangible items of fixed assets in total fixed assets, we obtain more detailed data. On the one hand, plant

and equipment in some entities have a 100% share in the total value of tangible fixed assets, which with a median of 24.44% indicates a large impact of valuation of this subgroup of fixed assets on the total value of fixed assets and indirectly on the value of total entity assets. On the other hand, the share of other real estate, plant and equipment in some entities reaches a maximum of 34.52%, but with a median of 3.64% indicates a relatively low ability of the applied concept of measurement after initial recognition of this type of tangible assets to affect the total value of fixed assets.

In the previous table, we could see a high percentage of sampled entities using the historical cost concept for measurement after initial recognition (C) of intangible assets (78%), while the percentage of entities using the fair value concept is only 7%. However, a very small number of sampled entities own intangible fixed assets. More precisely, the situation looks like this: one half of the sampled entities has a share of this type of fixed assets less than 0.62%, and the other half of the entities a share of more than 0.62%, while the maximum share of intangible assets in one entity was 11.78%. The sampled entities did not disclose information on the valuation of individual items of intangible assets, so we presented the data on the measurement after initial recognition of this type of fixed assets in aggregate form. How difficult it is to measure intangible assets best shows Thijssen & Iatridis's research (2016, p. 50) in which we can see that a result of conservatism can be decrease of the value of accounting information. Also, there are several methods of assessing the value of individual items of intangible assets, where as an example we can cite the assessment of the value of the brand. Yield methods of valuation are the most suitable for estimating the value of a brand, while the method of saving in royalties is the most common, although the method of excess yield and the method of incremental cash flow can also be used (Spasić, 2012, p. 259).

Kousenidis, Ladas & Negakis research (2009) shows a positive interconnection between the conservatism and accounting information value for persons who make decisions. But Basu's research (1997) shows a negative interconnection between the conservatism and the relevance of information. In other words, regardless of its numerous benefits, the application of the concept of historical cost has its shortcomings which, precisely, have decisively influenced the emergence of a new accounting concept – the concept of fair value.

II) Of tangible forms of fixed assets, sampled entities used the concept of fair value to a greater extent for the valuation of land, buildings and investment property. The level of impact of the measurement after initial recognition of these forms of tangible fixed assets based on the concept of fair value will be seen below.

Table 2: Measurement after initial recognition of d) land, e) buildings and f) investment property

Basis of measurement	D) Land		E) Buildings		F) Investment real estate	
	Number of entities	% of entities	Number of entities	% of entities	Number of entities	% of entities
Historical cost	10	37%	10	37%	7	26%
Fair value	12	44%	16	59%	19	70%
Not disclosed	1	4%	0	0%	0	0%
Entity does not have this type of assets	4	15%	1	4%	1	4%
Total	27	100%	27	100%	27	100%

Source: Arsenijević, 2020a, p. 244-259.

The table shows that the measurement after initial recognition of land (D) by 44% of the entities in the sample was performed on the basis of the concept of fair value, while 37% of the entities used the concept of historical cost. Despite the high share

of land in the fixed assets of some sampled entities (61.74%), the median of 5.65% indicates a relatively small impact of measurement after initial recognition of this item of fixed assets on the total value of fixed assets. Ex-post evaluation of buildings (E) has the opposite effect. Specifically, we see in the table that measurement after initial recognition of buildings by 59% of the entities in the sample was performed on the basis of the concept of fair value, while 37% of the entities used the concept of historical cost. The share of buildings in the total value of tangible fixed assets in one half of the sampled entities is less than 36.37%, while in the other half of the entities the share is higher than 36.37%, which (with a maximum share of 86.65%) makes this subgroup of fixed assets the most represented tangible assets in the sample. In other words, measurement after initial recognition of buildings at fair value has the potential to significantly affect the value of total fixed assets, and indirectly the value of total entity assets.

The item of tangible fixed assets that in the convincingly largest percentage of sampled entities (70%) is valued in accordance with the concept of fair value is investment property (F). In some entities, the share of these fixed assets in total assets is 70.35%, while the median is 11.11%, which is not a negligible figure when we know that all investment property is valued using the same method. Specifically, IAS 40 "Investment Property" for measurement after initial recognition allows a choice between the fair value method and the historical cost method, provided that the chosen method is indicated by the entity's accounting policy to be applied to all investment property (IAS 40, Paragraph 30). In addition to the above, the concept of fair value is used to value another item of fixed assets. These are biological assets that 7% of the sampled entities value at fair value. However, as only 0.004% is the maximum share of this type of tangible fixed assets in the total fixed assets of individual entities, we decided not to tabulate measurement after initial recognition of biological assets.

The financial form of fixed assets includes long-term financial investment and long-term receivables. The share of long-term receivables in the total fixed assets of the sampled entities is relatively low in the observed period and refers, above all, to receivables from parent and dependent legal entities, receivables based on sales on commodity credit and other long-term receivables. Some entities included in the sample have a significant share of long-term financial investment (some up to 100%) in total fixed assets, with one half of the sampled entities having a share of this type of fixed assets less than 13% and the other half more than 13% in total fixed assets. Our research came to the findings that show that almost half of the total number of sampled entities show the effects of changes in the fair value of long-term financial investments, which directly indicates the presence of the application of the concept of fair value for valuing this form of fixed assets. Given the share of this type of fixed assets in total fixed assets, the impact of the fair value concept on the total value of an entity's assets can be significant.

The weakness of the practical use of the concept of fair value refers to the lack of the market inputs due to the imperfection of an active capital market in developing countries such as our country. When it comes to our country, the quoted prices of shares and bonds from the Prime Listing of the Belgrade Stock Exchange are considered the first hierarchical level inputs. When we take into account that only four entities are listed on the Prime Listing, and that the volume of securities trading on this capital market is very low, we conclude that it is very difficult to expect first level input for many assets. However, to some extent there is an alternative. Specifically, "quoted prices of

agricultural products from the Product Exchange in Novi Sad, media publicly available real estate prices, catalog assessment of motor vehicles of the Auto Moto Association of Serbia” can be qualified as inputs of the first level (Negovanović, 2014, p. 182). For the aforementioned reasons, inputs from the second and third levels have been used more in the practice (Arsenijević, 2020b, p. 380). “An example of second-level input in our country is the market price of the company’s share located on the multilateral trading platform (MTP)” (Rupić & Bonić, 2015, p. 136), while the inputs of the third level of the theoretical construction are in accordance with IFRS 13.

III) A significant dimension of our research is to consider the impact of the method of measurement after initial recognition of fixed assets on the value of total assets of the entity based on the affiliation of the entity to a particular activity. Specifically, the entities from the total sample are divided by affiliation into 10 activities. The largest number of entities performs activities within (1) manufacturing industry (37% of the sample) and (2) from financial activities and insurance activities (25% of the sample), then (3) in the field of real estate and (4) construction (7% each) and, finally, one entity from each of the remaining six activities – (5) transport and storage, (6) wholesale and retail trade and repair of motor vehicles, (7) accommodation and food services, (8) education, (9) mining and (10) electricity, gas and steam supply (4% of the sample each). The largest share of fixed assets in the total assets is with entities engaged in transport and storage, wholesale and retail trade and repair of motor vehicles, manufacturing and real estate – more than 85%. The following are the entities that perform the activities of accommodation and food services, mining and financial activities and insurance activities – 77.59%, 75.24% and 76.66%, respectively. Entities from education (45.74%) and construction (36.96%) also have a significant share of fixed assets, while the entity in the field of electricity, gas and steam supply is the only one with a very low share of fixed assets in total assets (0, 92%). The foregoing statements support the representativeness of our sample to consider the impact of measurement after initial recognition of fixed assets on the value of the total assets of the entities and to draw relevant conclusions.

Empirical research has shown that when it comes to certain forms of fixed assets, most entities use historical cost only for certain items of these assets (for example, in measurement after initial recognition of intangible assets, plant and equipment, as well as other property, plant and equipment), while fair value is more often used for measurement after initial recognition of buildings, land, investment property and biological assets. In other words, on a practical example, we have shown that the mixed basis of financial reporting is the reality of the financial reporting of entities operating on the Serbian capital market. This conclusion is in line with the opinions of some theorists that “prudence and neutrality in the presentation of information in financial statements do not have to be mutually exclusive” (Škarić-Jovanović, 2015a, p. 80), and speaks of the real aspect of observing by accounting standards and market regulators who, knowing the relationship between the concept of historical cost and the concept of fair value, believe that the permeation of their requirements in utilization of combined basis of financial reporting results in increasing the usefulness of financial statements (Barth, 2014). “Loss of user confidence in the information presented in the financial statements would have unforeseeable consequences for the global financial market, and thus the global economy, because quality financial reporting is considered a basic prerequisite for stability and competitiveness of the global financial market” (Arsenijević & Đukić, 2017, p. 171).

Conclusion

Accelerated globalization of business and the formation of the world capital market have imposed transparency and timeliness of financial reporting as important issues. Business entities are facing increasing market uncertainty, but also less and less patience of their shareholders to achieve the highest possible dividends and capital gains in the shortest possible time. However, these are two mutually divergent demands placed on the entities. On the one hand, in order to survive on a dynamic market, it is necessary for entity managers to adhere to caution in decision-making, i.e. to base their decisions on the application of the principles of conservatism. On the other hand, the wishes of their shareholders can be realized only by applying the concept of fair value and recognizing unrealized gains. In other words, the survival of the entities and the growth and development of the entities are imposed on managers as alternative options. Therefore, the simultaneous use of the two concepts is a reality of current financial reporting, because growth and development are unthinkable without prior fulfillment of the conditions for the survival of the entity's business. The results of our research show that combined basis of financial reporting has been used by entities operating on the Serbian capital market.

Although future-oriented, the concept of fair value exhibits certain anomalies that prevent accountants from fully turning to the application of this principle alone. In that matter, positive aspects of the practicing of the conservatism "far outweigh its weaknesses" (Škarić-Jovanović, 2015a, p. 63), in the sense that, because of the conservatism, information value increasing instead of decreasing (Kousenidis, Ladas & Negakis, 2009, p. 220).

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