THE EFFECT OF CONSERVATISM AND PRECAUTIONARY PRINCIPLES ON THE REPORTING PRACTICES OF ECONOMIC ENTITIES

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Abstract:
Decisions of various stakeholder groups are no longer based exclusively on financial reporting. The global changes and multidimensional pressures (social, environmental, political, cultural, economic, etc.) have led to a stringent need to rethink the reporting processes. These take a variety of forms, ranging from "conventional" financial statements to the relatively recent reporting practices such as CSR reporting and value reporting. The present paper aims to analyze the effect generated by the application of two principles - conservatism (the differential verifiability required for recognition of profits versus losses) and precautionary (action to reduce environmental impact should not be delayed because of scientific uncertainty) - on various reporting practices.

Key words: *corporate social responsibility, social and environmental reporting, conservatism, precautionary principle.*

JEL classification: *M41, M48*

Introduction

Conventional financial reporting is based on the idea that although there are a number of identifiable users groups, the primary consumers of financial statements are the shareholders, prospective investors and financial intermediaries. The emergence of environmental reporting and other forms of corporate social responsibility reporting reflects the recognition that the span of corporate responsibility is changing to reflect the needs and interests of new stakeholder groups, including: employees, local communities, consumers, suppliers, as well as activists and lobby groups (FEE, 2000).

Over time, crises have had a visible impact on the reporting practices. It has been stated (Calu, 2005) that The Great Depression in 1929 – 1933 has contributed to the implementation of new rules regarding financial reporting, such as conservatism (prudence). For example, in Germany, the concept was introduced in the 1937 Stock Corporation Law (Aktiengesetz). Current events suggest a state of multidimensional crisis (economic and financial, social, environmental, political etc.) which is again acting as a stimulus to improve reporting practices. However, the global nature of the crisis shifts the focus from the economic entity to a more general level. While empirical results show that prudential accounting behaviours have intensified over the last few years (Lobo and Zhou, 2006) and have a direct influence on the impact of voluntary disclosures (Park et al., 2011), entity-level conservative practices should be matched by a similar behaviour at a global level. It takes the form of the precautionary principle.

This paper aims to analyse the effect generated by the application of two principles – prudence (conservatism) and precautionary - on various reporting practices. To realize this objective, the paper first addresses the issue of accounting conservatism (prudence), and then expands the scope of the analysis to include the implications of the precautionary principle. The effects of the precautionary principle in state-level regulations are taken into consideration in the context of political prudence.

Theoretical and methodological framework of the research

Decisions of various stakeholder groups are no longer based exclusively on financial reporting. The global changes and multidimensional pressures (social, environmental, political, cultural, economic, etc.) have led to a stringent need to rethink the reporting processes. These take a variety of forms, ranging from "conventional" financial statements to the relatively recent reporting practices such as CSR reporting.

This research brings into question two fundamental concepts that operate in different environments: prudence or conservatism (entity-level) and precaution (global). Starting from the significance of conservatism in the accounting regulations and reporting practices, the analysis is performed in the broader context of state and global public policies. Form a conceptual point of view, the analysis is structured on the following model (Figure 1):

Figure1. Prudence – precaution interdependencies

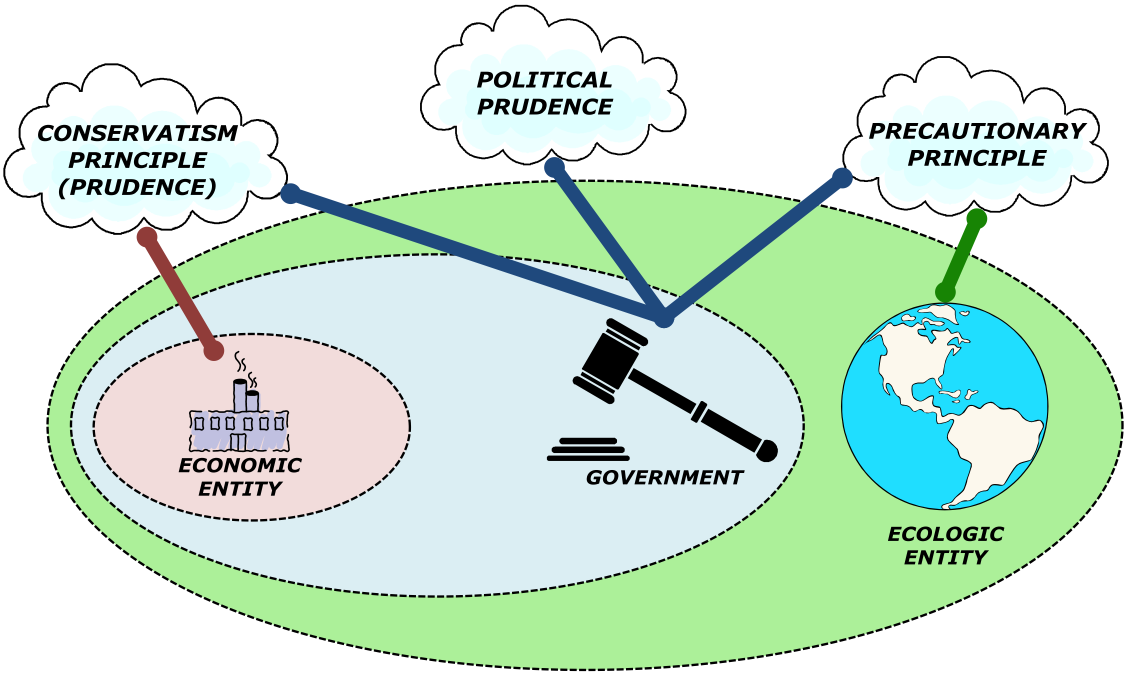

Table 1 presents a more detailed view of information regarding the interdependencies between the prudence and precautionary principles, on several levels of analysis.

Table1. *Prudence – precaution interdependencies on various levels of analysis*

Level of analysis	**Economic entity**	**State**	**Ecological entity**
Principle	**Accounting prudence**	**Political prudence**	**Precaution**
Scope	Financial and non-financial reporting	National public policies	Global public policies
Actions	Accounting treatments Reporting policies	Development and implementation of national policies where alternative solutions are	Development and implementation of global policies in high-risk and scientific uncertainty

		available	situations
Implementation instruments	Accounting regulations Professional standards Professional reasoning	Coercive regulations: - Environmental taxes - Mandatory insurance - Environmental standards	Regulations that are - Indicative *or* - Coercive.
Regulatory pressures	Receiver	Transmitter/ Mediator	Transmitter
Social and environmental impacts	Transmitter	Mediator	Receiver
Consequences: - Economic - Environmental	Diminished economic performance. Diminished negative impacts, social and environmental. Increased positive impacts, social and environmental.	Increase in revenues from taxes. Increase in quality of natural and social environment on a national scale.	Increase in quality of economic and social environment on a global scale. Biodiversity.

The trend of increasing critical nature of environmental issues and the growing vulnerability of a company's reputation are matters able to potentiate entity-level prudent behaviour. It must complement the global and national precautionary measures, in terms of negative effects generated by economic entities as pollutants.

The prudence principle and its consequences in financial and non-financial reporting

Basu (1995) argues that prudence has been influencing accounting over the past five hundred years. Pham (1989) and Colasse (1993) show that the principle has been acknowledged by jurisprudence since the late XIXth century; it was inseparable from the modus operandi of large stock companies and it was included in the Commercial Code (Code de Commerce, article 14). Sterling (1970) believes that prudence is the most powerful principle in accounting measurement. The growing role of prudential practices is also supported by Givoly and Hayn (2000).

From a conceptual point of view, the prudence principle is defined by reference to situations of uncertainty and risk affecting the elements of financial statements:

> *"…the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated"* (IASB Framework).

> *"…identical items will be treated differently depending on their classification as risks or opportunities"* (Schmalenbach, 1959)

"…a convention of asymmetry" (Ristea, 2003)

"…the on average understatement of the book value of net assets relative to their market value" (Beaver and Ryan, 2004)

"…the differential verifiability required for recognition of profits versus losses" (Watts, 2002)

The following behaviours are consistent with the prudence principle in accounting:

- No overstatement of assets or income and no understatement of liabilities or expenses are allowed, so as not to recognize unrealized benefits.
- Depreciations, foreseeable risks and potential losses during the financial year are taken into account, as well as those that occur between the balance sheet date and the date financial statements are authorized for publication.

Following the expression of entity-level prudent behaviour, two basic forms of manifestation are identified, as presented in Table 2.

Table2. *Entity-level prudent behaviour*

Domain	Forms of prudent accounting behaviours
Accounting treatments	• Accounting for probable liabilities and losses as provisions. • Recognizing the loss in asset value as depreciation adjustments; where inventories are concerned, this is the minimum of cost and net realisable value rule. • Recognizing the effect of start-up costs in the profit and loss account. • Recognizing the internally generated intangible items in the profit and loss account (immediate expensing of the costs of most internally developed intangibles). • Depreciation of property, plant, and equipment that is more accelerated than economic depreciation (accelerated depreciation).
Reporting policies	• Reporting of contingent assets and liabilities. • Description of causes that led to the recognition of provisions.

On a more technical note, applying the prudence principle requires a change in value for one or more of the following items: *increase in expenses, increase in liabilities,* and *increase in asset depreciation.*

If the application of prudence involves *the recognition of an expense,* we find it to be an ultra-prudent behaviour; the effect is a decrease in income and consequently financial resources are kept within the entity (there is a lower chance of distributing dividends if profits are diminished). This is the case of "classic" provisions, which entail a "twofold" prudent effect: the recognition of a probable liability *and* the recognition of an expense.

However, more recent accounting treatments have been established that entail a "moderately" prudent effect, in the sense that a liability is recognized, but in correlation with an asset and not an expense. This is the case of provisions for dismantling, removing or restoring the site, for activities/entities that make intense use of natural resources.

We note that prudence requires a higher degree of certainty for the recognition of income and other gains than for the recognition of expenses and other losses, which are essentially asymmetric verifiability requirements for gains and losses.

As the 2000 FEE report on environmental reporting shows, in non-financial reporting, exercising an appropriate degree of prudence means ensuring that:

- Adverse environmental impacts are not understated.
- Positive environmental progress is not overstated – for example by claiming that the entity is "sustainable" when this has not yet been proven.
- The reporting entity demonstrates its prudent anticipation of increasingly stringent social and environmental legislation.

The application of prudence in non-financial reporting does not mean that the reporting entities should omit positive items, but only restricting these reports to benefits that are certain and realized. For example, environmental expenses made to reduce discharges of waste must not be presented in non-financial reporting as an improvement in environmental quality.

Uncertainty is a very important factor in non-financial reporting and it is due to the global nature of environmental and social impacts that economic activities generate. These effects are not recognized by accounting unless a temporal, spatial and financial correlation can be established between an impact and the economic entity as a source. Otherwise, the so-called "external effects" or externalities emerge, social or environmental, positive or negative. The cumulative effect of these impacts is transmitted onto the more general levels of analysis. While some of the external effects are transmitted to the global entity, others can be taken over by the state, which uses the levers at its disposal to undertake measures so as to:

- Mitigate environmental impacts (remediation of contaminated sites where the contamination source is unknown or there is no legal framework for charging the costs to the polluting entity).
- Environmental protection (maintenance of protected areas as part of public domain, enforcement of environmental standards for granting building or other permits etc.).
- Social security systems (social security and unemployment for individuals that are not supported by the corporate environment).
- Health insurance system etc.

Even under these conditions, a series of social and environmental impacts remain unmatched by national systems and propagate on a global scale, requiring international instruments and solutions.

The prudent behaviour described above in the case of financial and non-financial reporting can be identified on a completely different scale, at the level of state entities. Form a conceptual point of view, the presence of a behaviour known as "political prudence" is identified. At the political level, prudence must not be understood as the inability to take action or to face new challenges, but as the "ability to discern the most suitable course of action" (The Oxford English Dictionary). It is the way the decision-making role of state authorities is manifested. Prudence is what Aristotle called "practical wisdom" (Andorno, 2004).

The link between political prudence and the precautionary principle resides in that precaution dictates the way in situations where the policy maker (states) must take decisions about products or activities (therefore decisions that impact economic entities) that are suspected as hazardous, but the hazard is not sufficiently understood. Precaution shifts the presumptions used in decision-making (Tickner, 1999) and puts the protection of the social and natural environment before economic interests. The classical image of prudence and especially the political form of this concept provides a useful framework for understanding the precautionary principle. Essentially, this relatively new approach is only a form of prudence in dealing with new technologies that have a potentially negative impact on the social and natural environment (Andorno, 2004).

The precautionary principle and its consequences on a macroeconomic and microeconomic scale

The precautionary principle has gained increasing global acceptance in environment, social and economic policymaking and it is mentioned in more and more international treaties: The Ministerial Declaration of the Second International Conference on the Protection of the North Sea (London, November 1987), The Third International Conference on the Protection of the North Sea (March, 1990), The Bergen Declaration on Sustainable Development (European Commission for Europe of the United Nations, 1990), The United Nations Conference on Environment and Development UNCED (1992), The Convention on Biological Diversity signed at the 1992 Conference on Environment and Development, the 1992 United Nations Framework Convention on Climate Change, the Cartagena Protocol on Biosafety (Montreal, 2000) etc.

Simply stated, the precautionary principle means that proponents of activities that might lead to serious or irreversible damage are obliged to take or permit measures to be taken to prevent this damage (including halting proposed activities), in spite of lack of full scientific certainty as to the existence of the risk, its nature or the potential damage (CISDL, 2002). The precautionary principle can be associated with prudence. Therefore, from the perspective of most stakeholder groups, *the prevention* of negative impacts is preferable as opposed to *remediation*. This prudential perspective was the foundation of the precautionary principle, which has often been quoted as a means of protection against new technologies and procedures with a potentially negative impact.

The application of the precautionary principle is illustrated by O'Riordan (2000) as follows:

- Actions must be taken before the holding of scientific evidence on the causes of impact.
- Decision-makers must take into account a margin of error due to lack of scientific evidence about social and environmental impacts of new technologies.
- A reversal of the report in bearing the negative external effect, to favour the affected parties instead of the sources of impact.

In these circumstances, we believe that non-financial reporting should include references to how the precautionary principle was incorporated into the environmental policies and programmes, as well as in the decision-making processes of the reporting entity.

The precautionary principle has two distinct facets, pertaining to the factors that trigger the recourse to the principle and to the measures resulting from its application. First, it is used for the political decision *to act or not to act*. Second, if an action is to be taken, the principle is meant to guide on *how to act*.

The implementation of the precautionary principle triggers a chain of events: on a global level (international), a convention is issued, or an agreement. This is assumed by the adhering countries, acting as mediators between the economic entities and the ecological entity. The role of mediator consists of overseeing the enforcement of the aforementioned convention by the economic entities (receivers), and also establishing economic limitations (through coercive measures) by charging "green" taxes.

To illustrate the relationship between the global entity (transmitter), the state (mediator) and the economic entity (receiver), we present the case of eco-efficient countries, where fiscal reforms have included green taxation (the tax on sulphur and CO_2 emissions in Sweden, the tax on CO_2 emissions in Norway). An interesting example regarding the application of the precautionary principle is the global and national solution to the issue of waste. Thus, the global Basel Convention was signed covering *transportation of hazardous waste across the borders.* Under this agreement, the externalization of waste propagation is limited. Consequently, the state is to mediate this role. Relevant in this regard is the case of the Northern European countries, which have succeeded in moving the pressure on economic entities (an expense is recognized), through a tax on waste.

Conclusions

The precautionary principle is essentially a call for caution addressed to policy-makers who decide about the products or activities with a potentially negative impact on the social and natural environment. The principle does not provide pre-determined solutions to problems that occur under conditions of scientific uncertainty, but it acts as a guiding principle and offers criteria to identify the most reasonable course of action in potentially hazardous situations.

As to the consequences of the precautionary principle, its responsible implementation should generate entity-level expenses and liabilities for any polluting agent that is a receiver of regulations enforced by states. In terms of effect on economic performance, the state-level precautionary approach is similar to an entity-level "ultra-prudent" behaviour.

The main contribution of the precautionary principle is that it has succeeded to reflect the current public concern about the need to favour the protection of global social and environmental interests over short term economic interests. As it was demonstrated by Ewald (1993), "the [precautionary] concept may prove to be one of major importance, and indeed one of paradigmatic value, not only with respect to the development of a policy of environmental protection, but also with respect to the development of a general framework of the law of social and private security" (in Cousy, 1996).

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