

## Economic Uncertainty Related to the Future and Accounting Conservatism<sup>1</sup>

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### INTRODUCTION

In the contemporary financial and economic landscape, investors are increasingly recognized as the pivotal drivers of growth and progress for business entities. Their role as catalysts underscores the critical importance of the information, they rely on to make investment decisions. This information often determines the allocation of resources and shapes the strategies of businesses seeking to thrive in competitive markets. Investors typically draw upon diverse sources of information, which can be broadly categorized into two groups: company-specific information and macroeconomic information. Company-specific information pertains to the internal dynamics of a firm, encompassing data such as financial performance, managerial changes, and strategic initiatives. This type of information is vital for understanding a company's unique attributes and potential risks. Conversely, macroeconomic information includes broader data that reflects the overall state of the economy, such as GDP growth,

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inflation rates, and monetary policy trends. This category of information impacts all companies and industries, providing a comprehensive context for investment decisions.

Both types of information play integral roles in guiding investment strategies. However, the interplay between macroeconomic conditions and company performance is particularly noteworthy. For instance, periods of economic growth typically result in increased demand for products and services, enhancing the financial performance of businesses. Such correlations highlight the necessity for investors and corporate managers alike to consider macroeconomic trends when making strategic decisions.

In this context, the concept of conservatism in financial reporting emerges as a critical factor. Conservatism entails exercising caution and precision in making financial estimates under conditions of uncertainty. It involves reporting revenues and assets at values lower than their actual figures while overstating expenses and liabilities. This approach ensures prudence, especially when dealing with ambiguous information. The degree of conservatism applied often correlates with the level of uncertainty and risk present in the decision-making environment. In situations with minimal uncertainty, conservatism may be deemed unnecessary. However, as uncertainty escalates, the need for conservatism becomes more pronounced.

Accounting conservatism serves multiple purposes, including fostering efficient investment decisions and enhancing oversight of managerial actions. By providing a more conservative view of financial performance, it mitigates the risks associated with over-optimistic projections and helps stakeholders make informed decisions. Conservatism is particularly relevant in environments characterized by high levels of uncertainty, where the potential for unfavorable outcomes necessitates a cautious approach.

## **METHODS AND MATERIALS**

The primary objective of this study is to investigate the relationship between economic uncertainty related to the future and accounting conservatism. This research adopts an applied approach, focusing on real-world implications and practical relevance. Methodologically, it is

categorized as a descriptive-correlational study, employing multivariate linear regression analysis to explore the relationships between variables. The study's dataset comprises panel data organized by companies and years, providing a robust framework for longitudinal analysis.

The analysis is grounded in empirical data drawn from the financial statements of companies listed on the Tehran Stock Exchange. As such, it aligns with the traditions of positivist and empirical accounting research. The statistical methods employed include descriptive statistics to summarize the characteristics of variables (e.g., mean, median, standard deviation) and inferential statistics to estimate regression coefficients and test hypotheses. The statistical population for this study consists of companies listed on the Tehran Stock Exchange. A purposive sampling method was employed to select a subset of these companies based on specific criteria, resulting in a final sample of 138 firms (equivalent to 690 firm-year observations) for the period from 2017 to 2021. This timeframe captures significant economic fluctuations, providing a rich context for examining the interplay between uncertainty and conservatism.

The study builds upon the conservatism measurement model proposed by Basu (1997), which has been widely adopted in accounting research. Basu's model evaluates conservatism through the asymmetrical recognition of good and bad news in accounting earnings. To enhance the model's applicability, this study incorporates economic uncertainty as an additional variable. Economic uncertainty is quantified using the GARCH model, which estimates the variance of errors for key economic indicators such as inflation rates, exchange rates, and economic indices. The calculated variances serve as proxies for economic uncertainty, either individually or as aggregated measures.

## **RESULTS AND DISCUSSION**

The findings reveal a significant and positive relationship between economic uncertainty and accounting conservatism. As economic uncertainty increases, companies tend to adopt more conservative accounting practices. This heightened conservatism manifests in greater sensitivity to bad news compared to good news, consistent with the

principles of accounting conservatism. These results underscore the pivotal role of uncertainty as a determinant of conservatism in financial reporting.

The study highlights that conservatism serves as a protective mechanism for companies navigating uncertain environments. By adopting conservative accounting practices, firms can mitigate the risks associated with over-optimistic projections and ensure greater alignment with stakeholder expectations. For instance, during periods of high uncertainty, earnings reports tend to reflect a more cautious outlook, prioritizing the recognition of potential losses over unrealized gains. This approach not only safeguards the firm's financial stability but also enhances its credibility with investors and creditors.

Investors, particularly those focused on companies with high financial constraints or significant equity commitments, are advised to pay close attention to the interplay between economic uncertainty and accounting conservatism. The findings suggest that companies exhibiting higher levels of conservatism are better equipped to navigate uncertain conditions, making them more attractive investment prospects. Conversely, firms with minimal conservatism may be perceived as riskier investments, particularly in volatile economic environments.

The study also emphasizes the role of managers in responding to economic uncertainty. In uncertain conditions, managers are expected to adopt more cautious strategies, balancing the need for short-term stability with long-term growth objectives. This cautious approach often involves revising financial forecasts, reevaluating investment plans, and enhancing risk management practices. By doing so, managers can provide external stakeholders with a clearer picture of the company's financial health, thereby strengthening stakeholder confidence.

Moreover, the findings have implications for shareholders and creditors, who increasingly expect managers to adopt conservative decision-making practices in the face of uncertainty. This expectation reflects a broader recognition of the value of conservatism as a tool for managing risk and ensuring financial resilience. By fostering a culture of conservatism,

companies can enhance their ability to weather economic fluctuations and maintain stakeholder trust.

## **CONCLUSION**

The study concludes that economic uncertainty is a significant determinant of accounting conservatism. Drawing upon Gallup's (1994) framework, the research identifies two primary effects of economic uncertainty: first, Decision-making deviations, where companies and consumers make choices that differ from their initial expectations. Second, post-decision impacts, where actual outcomes deviate from projected results, creating additional challenges for businesses. Government policies emerge as a key driver of economic uncertainty, particularly in contexts where short-term objectives (e.g., reducing unemployment) are prioritized over long-term considerations (e.g., managing inflation). This dynamic is especially pronounced in economies where governments play a dominant role, such as Iran. The study suggests that governmental actions significantly influence economic instability, underscoring the need for policymakers to adopt more sustainable approaches to economic management.

The research acknowledges several limitations, including the inability to control external factors such as global economic conditions, political developments, and regulatory changes. These variables, while beyond the researcher's control, may have influenced the observed relationships. Future studies are encouraged to address these limitations by incorporating a broader range of contextual factors. The study's findings offer practical insights for investors and market analysts. By recognizing the influence of economic uncertainty on accounting conservatism, stakeholders can better anticipate changes in financial reporting practices and make more informed investment decisions. For instance, companies exhibiting higher levels of conservatism may be viewed as forward-looking entities with strong strategic management.

In conclusion, the research highlights the importance of conservatism as a strategic response to economic uncertainty. By adopting conservative accounting practices, companies can enhance their financial stability,

foster stakeholder confidence, and position themselves for long-term success. These findings underscore the value of conservatism as both a risk management tool and a driver of strategic decision-making in today's dynamic economic environment.

**Keywords:** Economic Uncertainty, Conservatism, Stock Exchange.

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