**VIDEO SERIES: FAST FINANCE**

**No. 10: FINANCIAL STATEMENT CONSERVATISM**

**Conservatism in accounting**

Conservatism in accounting means that expenses and liabilities are recorded earlier than revenues and gains. This means that financial statements present a conservative view of a company’s health.

**Why are accountants conservative?**

Accountants measure companies conservatively to compensate for human nature. If allowed, managers of a business would be likely to take an optimistic view of their company’s financial performance. They would tend to delay reporting expenses and losses and to speed up and perhaps embellish revenues and gains. Financial accounting combats these natural tendencies.

Understanding the conservative nature of financial accounting will help you assess and interpret many managers’ assertions that financial statements do not “correctly” or “accurately” reflect their company’s activities.

**GAAP and conservatism**

Conservatism is a feature of generally accepted accounting principles (GAAP). GAAP is the set of principles and rules which businesses use to produce their financial statements. GAAP is enforced through corporate governance mechanisms including audits of the financial statements; regulations and laws enforced by the U.S. Securities and Exchange Commission; and ethics requirements for CPAs. In the U.S., public companies must disclose their financial statements four times per year.

Many businesses offer ‘pro-forma’ earnings, sometimes called ‘non-GAAP’ earnings, in addition to their regular financial statement disclosures. There is strong evidence that when managers present pro-forma earnings, they tend to exclude or underestimate expenses and losses.

**Example of conservatism**

Suppose a business spends money on research. Even if it is highly likely that the research will lead to new products that are salable, the money spent on research is an expense, and is recorded immediately. Revenue is only recorded at a future date when the new products are purchased by customers.