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The Moderating Role of Managerial Over Confidence on the Relationship between Accounting Conservatism and Financial Reports Opacity

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Abstract

This study aims to investigate the relationship between accounting conservatism and the lack of transparency in financial reports, while considering variations in managerial overconfidence. Therefore, the research was carried out on a subset of banks that are publicly traded on the Iraqi Stock Exchange. The study utilized a quantitative methodology to assess the factors by analyzing the financial records of 17 institutions. The sample comprised institutions that adopted integrated disclosure between 2013 and 2022. The results suggest a robust and favorable association between accounting conservatism and the lack of transparency in financial statements. Moreover, the existence of managerial overconfidence significantly affects the correlation between accounting conservatism and the lack of transparency in financial reports. Our research makes a substantial contribution to the accounting literature by proposing innovative and original concepts, and by enhancing the quality and significance of information for all stakeholders. The research question addressed in this study is regarded as a crucial trend in contemporary accounting thought.

Keywords: *Accounting conservatism; Financial reports opacity; Managerial overconfidence*

1. Introduction

Users of financial reports have paid due attention to financial reports opacity, especially after many crises in some international companies as some managers have favored special interests, causing a decline in the transparency and credibility and inadequacy of financial reports to users' needs. Additionally, the rational practice of accounting conservatism is critical to maintain the credibility of these reports. Due to the different levels of accounting conservatism and the financial reports opacity from one company to another, which may be due to behavioral factors and determinants of managers, especially managerial overconfidence, they directly or indirectly affect accounting conservatism and financial reports opacity. Thus, several reasons urged the investigation of the topic understudy, especially the controversy on financial reports opacity resulting from traditional measurement and disclosure concepts and methods in the Iraqi context. The present study is an attempt to bridge the research gap due to the lack of Arab or foreign studies, to the knowledge of the researchers, on the topic.

The problem of the study has been defined in asking the following questions:

a. Does the relationship between accounting conservatism and financial reports opacity differ under managerial overconfidence?

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b. To what extent does accounting conservatism affect the financial reports opacity?
c. To what extent does managerial overconfidence affect the financial reports opacity?
d. To what extent does the effect of accounting conservatism on the financial reports opacity differ under managerial overconfidence?

Objectives

Based on the nature of the study problem, the study mainly aimed to test the extent to which the effect of accounting conservatism on the financial reports opacity varies under the managerial overconfidence of Iraqi banks.

Considering the problem and objective of the study, the hypotheses were created as follows:

H1. *The relationship of accounting conservatism with financial reports opacity varies under managerial overconfidence.*
H2. *There is a significant effect of accounting conservatism on the financial reports opacity.*
H3. *There is a significant effect of managerial overconfidence on the financial reports opacity.*
H4. *The effect of accounting conservatism on the financial reports opacity varies under managerial overconfidence.*

2. Literature Review

2.1 Accounting Conservatism

Accounting conservatism is called caution, prudence, or discretion. It represents an important accounting dimension because it is one of the traditional accounting principles and a basic cornerstone for accountants worldwide. The practice of accounting conservatism varies from one country to another (Al-Jabouri, 2019). Financial accounting literature has illustrated that accounting conservatism is the oldest and perhaps the most widespread accounting valuation principle (Lakshminarayan, 2018). As a concept, conservatism resulted from experience, not logic (Orthaus et al., 2023), as its application dates to the fourteenth century. It was applied to confront conditions of uncertainty and to protect creditors. Although it was used in accounting practice a long time ago, academic applied research significantly over the past decade, coinciding with the increasing demand for conservatism by users of financial reports (Muhammad, 2014).

The International Accounting Standards Board explicitly indicated accounting conservatism as (mindfulness) in the revised financial declaration of (2018) as "the practice of mindfulness when making judgments under conditions of uncertainty." The Board also referred to the need for mindfulness in valuating assets, liabilities, and financial returns (Al-Absi, 2023). Recent literature suggests that accounting conservatism is a critical characteristic of accounting that facilitates the flow of the company's private information from corporate insiders to external parties and a key mechanism that improves the effectiveness of corporate governance and prevents managerial opportunism (Al-Rifai et al., 2023). Accounting conservatism is employed when the economic value of a company's equity exceeds its book value (Barker, 2015). According to the concept statement no. (2) of the International Accounting Standards Board, conservatism is a mindful reaction to uncertainty when preparing financial reports (Hejranijamil et al., 2020).

Accounting conservatism can be categorized into two distinct types: unconditional and conditional. The fundamental difference is in the fact that the former solely relies on information available at the start of the asset's life cycle, whereas conditional conservatism

incorporates information disclosed in future periods as it is received (Basu, 2005). Researchers offer several patterns and justifications for conservative financial reports, each suggesting that accounting conservatism is advantageous for viewers of financial reports (Watts, 2003). The objective of conservative financial reporting is to enhance the effectiveness of contracts, discourage legal action by shareholders against companies and auditors, enhance the accuracy of financial information through regulatory involvement, and minimize or postpone income tax obligations (Petruska et al., 2013).

2.2 Financial Reports Opacity

Kerr (2012) agreed with Bushee (2012) on defining financial reports opacity as the lack of the company's information to those outside the company. Ding et al. (2020) suggested that financial reports opacity represents the lack of information that prevents investors from determining the fair value of the company because the outside parties of the company cannot obtain sound accounting information related to the company issuing financial reports (Muhammad, 2022). Fuad et al. (2023) illustrated that financial reports opacity is a type of non-probabilistic uncertainty, referring to a situation in which the probability of events is unknown and the results are difficult to predict as companies lack adequate data to determine business outcomes.

Focusing on the concept of financial reports opacity, Ali (2023) provided a comprehensive definition as a disclosure strategy designed by the company's management and results from the opportunistic behavior of management, enabling them to deliberately influence the preparation of financial reports and management of disclosure activities. Opacity implies the company's management's ability to undisclose bad news or essential information by deliberately controlling the amount and content of information, manipulating the results of poor performance, restricting or confusing disclosure by the brief presentation, and using the structure of language to formulate financial reports opacity.

Financial reports opacity results from the flexibility of available accounting rules and policies in treating the items of the financial reports in light of the freedom of using alternative methods to handle the same economic events, using accounting conservatism in valuation for the financial reporting items, the lack of disclosures about accounting valuation processes, the lack of meeting the requirements of accounting standards, and distorting and changing accounting numbers by exploiting gaps in accounting standards (Abdul Rahim, 2022). Hillebrand and Bigus (2016) reported aspects of financial reports opacity, namely absolute discretionary accruals, lack of timeliness of disclosure, and brief financial reports.

Financial reports opacity causes many risks, such as information asymmetry, increased agency problems, uncertainty risks, and financial collapse and bankruptcy risks. Accordingly, in October 1998, the US Securities and Exchange Commission called for "plain language" disclosure rules, as companies can use opacity language to hide negative information. Ordinary investors may not be able to understand the financial reports opacity (Dempsey et al., 2012).

2.3 Managerial Overconfidence

Managerial overconfidence is a common behavioral bias in decision-making (Mohamed, 2022). Since the financial crisis in 2008, perspectives have changed with the lack of confidence in corporate management, requiring significant research attention to the personal traits of managers, especially their overconfidence in voluntary disclosure (Alqatamin et al., 2017).

Overconfidence is a key intangible characteristic that impacts the corporate's performance (Zamel & Al-Sayed, 2021). It is also a major reason for the collapse and failure of many corporates. For example, Jeffrey Skilling, former CEO of Enron, had overconfidence and believed that he could manipulate financial reports regularly without being noticed, but his overconfidence caused Enron's financial collapse (Ali and Awad, 2021).

Managerial overconfidence is defined as overestimating investment returns. Overconfident managers overestimate investments if they have sufficient internal funds or can access risk-free debt financing (Malmendier et al., 2011). Overconfidence means overestimating an individual's abilities and the results related to one's personal situation. An individual's overconfidence has two main aspects: misjudgment and the error of excessive optimism (Alqatamin et al., 2017). Managerial overconfidence is a trait that changes over time, which is difficult to assess in advance. Companies are unlikely to look for managers with a given level of overconfidence (Hsu et al., 2017).

Managers with overconfidence are seen as innovative and play a key role in the success of companies. Still, they are undesirable because they destroy the value of the company by taking more risks (Habib & Hossain, 2013). Managerial overconfidence based on knowledge, skills, and capabilities is positive and benefits shareholders and financial performance. It helps employ growth opportunities more effectively and encourages sustainable performance (Muhammad and Baghdad, 2019). In contrast, overconfidence affects accounting decisions and financial reports (Killins et al., 2021) because the operations carried out by overconfident managers are random and confused with harmful financial effects on the company's present and future performance, The hindrance of its ability to persist necessitates extensive effort from the auditor, including the necessity to augment the sample size in order to form a suitable assessment of the integrity and accuracy of the balances and records, which results in a high cost of external auditing (Muhammad, 2022).

2.4 Relationship between Accounting Conservatism, Financial Reports Opacity, and Managerial Overconfidence

According to Abdel Halim et al. (2022), accounting conservatism can reduce the quality of financial reports because it reduces the relevant value of the information and increases the quality of financial reports. It limits the practice of earnings management and reduces the asymmetry of information. Abdul Khaleq (2023) confirmed that the use of conservative accounting policies helps improve the quality of information in financial reports and reduces opportunistic management behavior, promoting the reliability of accounting information. Moreover, Shahid and Abs (2018) indicated that accounting conservatism brings benefits to the contracting parties, including management, shareholders, and creditors, as it uses a mechanism to offset information asymmetry and achieves a high degree of transparency in the preparation of financial reports.

Many users of financial reports desire accounting conservatism within the conceptual framework to protect their interests. Demanding conservatism protects investors and debtors from opportunistic managerial behavior (Conway, 2020). Therefore, Othman et al. (2022) stressed There is an inverse correlation between managerial overconfidence and accounting conservatism, illustrating a decrease in managerial overconfidence in companies that use conservative accounting policies. Accounting conservatism is used to limit the excessive optimism of management and owners and also protect debtors against any unjustified and unnecessary distribution of the company's assets (Al-Balqawi, 2009). Information in financial

reports is affected by the environment in which it is produced as a result of the interaction of various factors, including managerial overconfidence (Takamatsu & Fávero, 2017). According to Samaan (2020), managerial overconfidence increases the risks of financial reports and causes poor disclosure of financial reports, increasing the possibility of financial reports opacity. Mohamed (2022) reported that managerial overconfidence leads to making decisions that inherently reflect the work of the accounting system. Given the impact of managerial overconfidence on financial reports, it is important to take into account its impact on accounting and financial policies. Therefore, managerial overconfidence ultimately leads to optimistically biased financial reporting.

3. Methodology and Discussion

3.1 Sampling

The population consisted of all banks that were listed on the Iraq Stock Exchange. The banking sector was chosen as a crucial industry that has a substantial part in determining the success or failure of the economy, since it contributes to the growth of both local and global economies. Furthermore, it encompasses the highest quantity of companies, accounting for 35% of the companies listed on the Iraq Stock Exchange. The sample consisted of (17) banks and was derived from the consistent and uninterrupted disclosure of financial information. The temporal boundaries spanned a duration of ten years, specifically from 2013 to 2022. During this period, a total of 170 observations were conducted per annum.

3.2 Variable Measurement

- The independent variable (accounting conservatism) was based on the model of (Ryan& Beaver, 2000) and the study of (Biddle et al.,2013). When the result of the market value model to the book value is less than one, it suggests a lack of accounting conservatism. In contrast, if the result is more than one, it suggests accounting conservatism (Ali, 2022).
- The dependent variable (financial reports opacity) was measured according to the model of (Dechow, 1995) by the moving sum of the total discretionary accruals for three consecutive periods according to the following steps (Andreou et al., 2022).

Step One: Define the value of total accruals

$$TACC_{it} = NI_{it} - OCF_{it} \quad \ldots\ldots.. (1)$$

Where

$TACC_{it}$= total accruals of the company i in the year t.

NI_{it}= income before extraordinary items of the company i in the year t.

OCF_{it} =cash flow from operating activities of the company i in the year t.

Step Two: Estimate the cross-sectional regression equation according to the following one:

$$TACC_{it} / Assets_{i.t-1} = \alpha_0(1/Assets_{i.t-1}) + \beta_1 (\Delta REV_{it} / Assets_{i.t-1}) + \beta_2(PPE_{it} / Assets_{i.t-1}) + \varepsilon_{it}..$$

$TACC_{it} / Assets_{i,t-1}$: total accruals divided by the total assets of the previous year.

$Assets_{i,t-1}$: total assets of the company i in the previous year t-1.

ΔREV_{it}: The annual change of the incomes of the company i from the previous year t-1 to the current year t.

PPE_{it}: denotes the tangible assets (property, plant, and equipment) of the company i in the year t.

$\alpha_0, \beta_1, \beta_2$: the estimated value of the models' parameters used to calculate discretionary accruals

ε_{it}: denotes the residuals of the regression model.

Step Three: Calculate the value of non-discretionary accruals according to the following equation

$$NACC_{it} = \alpha_0(1/Assets_{i,t-1}) + \beta_1((\Delta REV_{it} - \Delta Reci_{it}) / Assets_{i,t-1}) + \beta_2 (PPE_{it} / Assets_{i,t-1}) + \varepsilon_{it} \ldots$$

Where

$NACC_{it}$: denotes the non-discretionary accruals of the company i in the year t.

Step Four: Calculate the value of discretionary accruals according to the following equation

$$DISACC_{it} = TACC_{it} - NACC_{it} \ldots\ldots.. (4)$$

$DISACC_{it}$: denotes the calculations of the discretionary accruals of the company i in the year t.

Step Five: Calculate the moving average absolute value of discretionary accruals: All absolute values of discretionary accruals are calculated over three previous years (t-1, t-2, and t-3) to determine the value of financial reports opacity of the year understudy (Yupeng Lin, 2014).

$$OPACITY_{it} = AbsV(DISACC_{i,t-1}) + AbsV(DISACC_{i,t-2}) + AbsV(DISACC_{i,t-3}) \ldots(5)$$

$OPACITY_{it}$: denotes opacity of the financial reports of the the company i in the year t.

$AbsV(DISACC_{i,t-1})$: denotes the absolute value discretionary accruals of the company i in the year t-1.

$AbsV(DISACC_{i,t-2})$: denotes the absolute value discretionary accruals of the company i in the year t-2.

$AbsV(DISACC_{i,t-3})$: denotes the absolute value discretionary accruals of the company i in the year t-3.

Step Six: Determine the value of financial reports opacity. The higher moving average absolute value of discretionary accruals indicates opacity. In contrast, the decline of the value to near zero suggests the decline in financial reports opacity (Alsawah, 2022).

3. Interaction variable (managerial overconfidence) was measured using a dummy variable, equaling (1). A manager is overconfident if the residuals of the regression model have a positive value. Otherwise, a manager takes (0) (Hussien, 2023) (Ahmed & Duellman, 2013)

$$\Delta Asset_{it} / Asset_{i,t-1} = \alpha_1 + \alpha_2 \, \Delta Sales_{it} / Sales_{i,t-1} + \varepsilon_{it}$$

$\Delta Asset_{it}$: total change of the assets of the company *i* in the year *t*.

$Asset_{i,t-1}$: total assets of the company *i* in the previous year *t-1*.

$\Delta Sales_{it}$: total change of income (sales) of the company *i* in the year *t*.

$Sales_{i,t-1}$: total change of income (sales) of the company *i* in the previous year *t-1*.

a. Test of Linear Correlation Between Variables

The Pearson correlation coefficient was employed to assess the magnitude and direction of the association between the variables. Table (1) displays the correlation coefficients among the variables as follows:

Table (1): Linear Correlation Between Variables.

Variable		managerial overconfidence	financial reports opacity
accounting conservatism	Pearson value	0.156*	0.466**
	(Sig.)	0.042	0.000
financial reports opacity	Pearson value	0.005	1
	(Sig.)	0.951	

Source: The table is Prepared by the Researchers based on the Results of SPSS.

Table (1) illustrates a positive significant correlation between accounting conservatism and the dependent variable (financial reports opacity) and the interaction variable (managerial overconfidence). Whenever accounting conservatism increases, financial reports opacity and managerial overconfidence increase. Moreover, there is no significant relationship between financial reports opacity and managerial overconfidence.

b. Testing and Discussion of Hypothesis

H1. *The relationship of accounting conservatism with financial reports opacity varies under managerial overconfidence.*

Partial Correlation can be used to test the partial relationship between the three study variables. Table (2) shows the results of testing the level of difference in the relationship between the variables.

Table (2): Results of Testing H1.

Variable		Accounting conservatism	Accounting conservatism
		Exclusion of managerial overconfidence	inclusion of managerial overconfidence
Accounting conservatism	Pearson value	0.471**	0.466**
	(Sig.)	0.000	0.000

Source: The Table is Prepared by the Researchers Using SPSS.

Table (2) shows that when managerial overconfidence is excluded, the positive significant relationship between accounting conservatism and financial reports opacity becomes slightly more positive, suggesting that managerial overconfidence affects the strength and significance of the relationship between accounting conservatism and financial reports opacity. Therefore, H1 (the relationship of accounting conservatism with financial reports opacity varies under managerial overconfidence) is accepted.

H2. *There is a Significant Effect of Accounting Conservatism on the Financial Reports Opacity.*

A simple linear regression equation can be developed to estimate the financial reports opacity

in terms of accounting conservatism in order to determine the extent of the latter's influence on the financial reports opacity as follows:

$Y_{it} = \beta_0 + \beta 1 X + \varepsilon_{it}$

Table (3): Effect of Accounting Conservatism on Financial Reports Opacity.

Variable	R^2	Adjusted R^2	F	Sig.
accounting conservatism	0.217	0.213	46.696	0.000
	Variable coefficient β0	Regression coefficient β	T	Sig.
	0.093	0.922	6.833	0.000

Source: The Table is Prepared by the Researchers Using SPSS.

Table (3) supports the validity of the regression model by showing that the (F) value is significant at (46.696) with a significance level of (5%). This suggests that the financial reports opacity may be approximated based on accounting conservatism, thereby confirming the validity of the model. The (T) value of (6.833) at a significance level of (5%) indicates a statistically significant impact of accounting conservatism on the opacity of financial reports. The beta (β) value of 0.922 suggests a good effect. In other words, as the degree of accounting conservatism increases, the level of opacity in financial reporting also increases. The Adjusted R2 value of 0.217 indicates that accounting conservatism explains 21.7% of the variations in the opacity of financial reports. The mathematical model can be expressed as the subsequent linear equation:

$Y_{it} = 0.093 + 0.922 X + \varepsilon_{it}$

Based on the statistical results that explain the significance of the regression equation, H2, which states (There is a significant effect of accounting conservatism on the financial reports opacity.) is accepted.

H3. *There is a Significant Effect of Managerial Overconfidence on the Financial Reports Opacity.*

In order to test the hypothesis, a basic linear regression model was constructed to assess the level of influence that managerial overconfidence has on the opacity of financial reports. The model aimed to evaluate the amount to which managerial overconfidence affects the opacity of financial reports. $Y_{it} = \beta_0 + \beta_1 M + \varepsilon_{it}$

Table (4): Effect of Managerial Overconfidence on the Financial Reports Opacity.

Variable	R^2	Adjusted R^2	F	Sig.
Managerial overconfidence	0.000	-0.006	0.004	0.951
	Variable coefficient β0	Regression coefficient β	T	Sig.
	0.558	0.007	0.062	0.951

Source: The Table is Prepared by the Researchers Using SPSS.

Table (4) reveals the lack of validity of the regression model due to the low significance of the (F) value of (0.004) at a significance level of (5%). This suggests that it is not possible to evaluate the opacity of financial reports in relation to managerial overconfidence, hence indicating the invalidity of the model. The (T) statistic of (0.062) at a significance level greater than (5%) indicates that there is no significant impact of managerial overconfidence on financial reports opacity. The beta (β) value of 0.007 suggests a positive effect. The Adjusted R2 value of 0.000

indicates that managerial overconfidence explains 0% of the variations in the opacity of financial reports. The mathematical model can be expressed as the subsequent linear equation:

$Y_{it} = 0.558 + 0.007\ M + \varepsilon_{it}$

Thus, H3 (There is a significant effect of managerial overconfidence on the financial reports opacity.) is null.

H4. *The effect of accounting conservatism on the financial reports opacity varies under managerial overconfidence.*

A simple linear regression model can be developed to estimate the financial reports opacity regarding accounting conservatism and managerial overconfidence as an interaction variable, as follows:

$Y_{it}= \beta_0 +\beta_1\ X+\beta_2\ M+\beta_3\ (X*M)+\varepsilon$

Table (5): Results of Testing H4.

Variable	R^2	Adjusted R^2	F	Sig.
	0.257	0.243	19.098	0.000
	Variable coefficient (β0)	Regression coefficient (β)	T	Sig.
Accounting conservatism X	-0.051	1.317	6.931	0.000
Managerial overconfidence M		0.288	1.723	0.087
)X_M(		-0.742	-2.769	0.006

Source: The Table is Prepared by the Researchers Using SPSS.

Table (5) demonstrates the validity of the regression model by showing that the (F) value is significant at (19.089) with a significance level of (5%). This suggests that the interaction variable of financial reports opacity, accounting conservatism, and managerial overconfidence can be evaluated, thus confirming the validity of the model. The (T) value at a significance level of (5%) indicates that managerial overconfidence has a substantial influence as an interaction variable in the important association between the accounting conservatism variable and financial reporting opacity. The negative beta (β) value of (X_M) signifies the presence of a negative influence. In other words, when the level of managerial overconfidence is higher as an interaction variable, the impact of accounting conservatism in raising the opacity of financial reporting becomes smaller. The Adjusted R2 value of 0.243 indicates that the combination of management overconfidence as an interaction variable and accounting conservatism accounts for 24.3% of the variations seen in the financial reporting opacity. The mathematical model can be expressed by the subsequent equation:

$Y_{it}= -0.051 +1.317\ X+0.288\ M- 0.742\ (X*M)+\varepsilon$

Based on the statistical results, H4 (the effect of accounting conservatism on the financial reports opacity varies under managerial overconfidence) is accepted.

4. Conclusions

This study attempted to combine some accounting variables (accounting conservatism and financial reports opacity) with managerial overconfidence, which is one of the recent variables

within behavioral finance that has not received sufficient attention from the accounting and financial literature. A managerial overconfidence greatly affects how companies' performance and decisions are measured and interpreted. A managerial overconfidence is a double-edged sword, and although confidence among managers contributes to enhancing innovation and achieving sustainable performance related to the future of the company, exaggeration in financial forecasts, estimation of future returns and financial risks, and underestimation of the lack of influence of political and legal events in the environment surrounding the company threatens its continuity in activity. As is the case with previous studies, this study faced many limitations, including the lack of previous studies related wholly or partially to the variables of this study. This is due to the lack of focus of previous accounting studies on the variables (managerial overconfidence and financial reports opacity), despite their importance. We were also unable to obtain the necessary data for some other banks during the study period due to the varying periods of listing of these banks in the Iraqi Stock Exchange and the exit of others from this market. However, reliable and generalizable results were reached.

The study focused on a sample of banks that are listed on the Iraq Stock Exchange. The analysis covered the period from 2013 to 2022. The study encompassed a total of 17 banks, resulting in 170 approved observations. Upon conducting hypothesis testing and analyzing the obtained results, the study reached the conclusion that a relationship exists. There is a direct relationship between accounting conservatism and financial reports opacity. Specifically, as accounting conservatism increases, there is a corresponding increase in financial reporting opacity. The association between accounting conservatism and the opacity of financial reports is influenced by the presence of excessive managerial overconfidence. This paper proposes that academics investigate the correlation between ambiguity and complexity in financial reports. We suggest that the governing bodies overseeing the accounting profession should identify alternative accounting concepts that are subject to various interpretations by company management and accountants. They should also avoid incorporating probabilistic interpretations into the standards. This will help to minimize the level of flexibility permitted and reduce the discretion granted to management, ultimately reducing excessive confidence and opacity in financial reports.

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