Board Characteristics’ Impact on Accounting Conservatism Before and During the Financial Crisis

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ABSTRACT

This article investigates the extent that board characteristics and board strengths influence the accounting conservatism, estimated by market-based and accrual-based measures, before and during the financial crisis. The percentage of inside directors and the additional directorships (board characteristics) were negatively related to market-based conservatism. This relationship is weaker for the period during the financial crisis compared to the period before the crisis. The negative relationship found between CEO and chairman duality and accrual-based conservatism is weaker during the financial crisis than before the crisis, which implies that the financial crisis can be considered as an important element that leads to failures and weaknesses in corporate governance mechanisms. The results hold after controlling for inside directors’ ownership, leverage, firm size, sales growth, sales opportunities, profitability and litigation risk, as well as for unobservable firm characteristics that are stable over time by using fixed effects regressions.

KEYWORDS

Accounting Conservatism, Board Characteristics, Corporate Governance Mechanisms, Financial Crisis

INTRODUCTION

Many accountants believe that conservatism is an appropriate approach to making accounting decisions, because managers, investors and accountants prefer possible errors in measurement in the direction of understatement rather than overstatement of net income and net assets. The reason for the existence of conservatism is that business and economic activities operate constantly in uncertainties (FASB, 1980).

Accounting conservatism exists when firms recognize losses more quickly than profits (Watts, 2003). Creditors are the main beneficiaries from conservatism because the understatement of net income and net assets protects these external users (Hellman, 2008). The use of conservative accounting treatment in contracts with different parties will decrease information asymmetry and moral hazard problems, which arise from agency conflicts (García Lara et al., 2007).

Despite its important benefits, accounting conservatism is criticized as a threat to the relevance of accounting data, because it is a poor method to measure the uncertainty in valuation and in income and, hence, revenues are recognized too late and expenditures too early (Hellman, 2008; Kalantonis,
2016). The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) support that conservatism damages the quality of financial reporting information (IASB, 2006) and they prefer to focus more on future-oriented financial reporting and improve the relevance of financial reporting. On the contrary, accounting conservatism implies a focus to past events. Moreover, according to the FASB (1980), conservatism is incongruent with some other qualitative characteristics, such as neutrality, comparability, consistency and representational faithfulness. However, Givoly & Hayn (2000) reported a significant increase of accounting conservatism in the last few decades.

The board of directors is a corporate governance mechanism, which encompasses all the provisions and mechanisms that guarantee that the assets of a company are managed efficiently and in the interest of the capital providers. One important duty of the board of directors is to monitor the managers and evaluate their activities within the company (Beekes et al., 2004; Fama & Jensen, 1983; García Lara et al., 2007). Accordingly, an adequate and effective governance will lead to better monitoring and supervising of management, because conservative accounting can mitigate agency costs and reduce litigation risk for directors, auditors and managers. Therefore, it is expected that an adequate corporate governance mechanism will favor conservative accounting treatment and information due to accelerating the recognition of bad news. Thus, accounting conservatism functions as an early warning signal to the board of directors, by providing a timely investigation into the reasons for bad news (García Lara et al., 2009).

Although there are several prior studies about the relationship between the board characteristics and accounting conservatism under regular market conditions, it is rather interesting to investigate this relationship during the financial crisis. This is because corporate governance plays an important role in increasing firm performance and value, but it could be affected by financial exogenous shocks (Aldamen et al., 2012). Thus, the main aim, and contribution, of this study is the inquiry of the potential impact of the board characteristics and board strengths on accounting conservatism before and during the financial crisis. Moreover, this study contributes by incorporating in the analysis the financial and insurance sectors which were excluded in relevant prior research (Ahmed and Duellman, 2007). The next section refers to the literature review about accounting conservatism and its association with corporate governance and board characteristics, followed by the research hypotheses, the research methodology and the sample selection process. Subsequently, the research results are discussed, and eventually, our conclusions, limitations and proposals are reported.

**LITERATURE REVIEW**

**Accounting Conservatism**

There are many definitions of conservative accounting (Penman & Zhang, 2002), with the traditional being “...anticipate no profits but anticipate all losses...” (Bliss, 1924). However, this expression is considered extreme in the modern accounting world, and the modern definitions (Francis et al., 2013; Givoly & Hayn, 2000; LaFond & Roychowdhury, 2008) are based mainly on the interpretations of both Basu (1997) and Feltham & Ohlson (1995). Basu (1997, p. 4) states: “I interpret conservatism as capturing accountants’ tendency to require a higher degree of verification for recognizing good news than bad news in financial statements,” which means that earnings reflect bad news faster than good news. Thus, managers recognize unrealized losses earlier than unrealized gains, which lead to an asymmetry in the timeliness and persistence of earnings. Therefore, he predicts that earnings are timelier and more sensitive in reflecting publicly available ‘bad news’ than ‘good news’. With ‘bad news’ he means the negative unexpected annual stock returns as a proxy and ‘good news’ the positive unexpected annual stock returns (Basu, 1997). Feltham & Ohlson (1995) characterize conservative accounting as ‘biased’ accounting arguing that conservative accounting occurs when the market value equals or exceeds the book value of an asset. They support that ‘unbiased’ accounting results in full capitalization of an initial investment in operating assets, while ‘biased’ (conservative) accounting
IFRS Adoption in the EU and the Challenge of Nomenclature Evidence from the UK, France, and Germany