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Accounting conservatism in a setting of Information Asymmetry between majority and minority shareholders

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Abstract

Following LaFond and Watts (2008), we examine the relation between information asymmetry (as measured by PIN, probability of information-based trading) and accounting conservatism but focus on a country – Taiwan – whose institutional background is different from that of the United States. Due to the disparate degree of conservatism across the world, the conclusions of LaFond & Watts (2008) might not be universally applicable. Our findings support, in general, the applicability of their conclusion to a Taiwan data set. We find, however, that the effect of PIN appears weaker when auditor tenure is taken into account, thus supplementing their conclusions.

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Keywords: Accounting conservatism; Information asymmetry; PIN (Probability of Information based on Trading)

1. Introduction

The recent *Conceptual Framework for Financial Reporting* project, a joint project of the International Accounting Standards Board (IASB) and the U.S. Financial Accounting Standards Board (FASB), concludes that conservatism (or prudence) should be excluded from the qualitative characteristics of accounting information. This conclusion motivates us to examine the informational role of conservatism (detailed in the literature review section),¹ the demand for

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¹ Regarding the joint project and the debate of the two boards, refer to Gassen (2008). In addition, Ball, Kothari, and Nikolaev (2009) provide a fairly comprehensive list of papers on conservatism. Besides, as we finish this paper, the joint project of IASB and FASB is still ongoing. All materials can be downloaded at http://www.fasb.org/project/conceptual_framework.shtml.

and measurement of which have long been examined and explained by researchers (e.g., Basu, 1997; Roychowdhury & Watts, 2007). If carried out, this exclusion will affect the development of future accounting standards. Therefore, this study examines the impact of conditional conservatism on shareholders, focusing mainly on private information and auditor tenure.

Two important features of conservative accounting are *asymmetric* timeliness in recognition of accounting gains versus losses and *systematic* understatement of net assets (Givoly, Hayn & Natarajan, 2007; Roychowdhury & Watts, 2007), features that result from asymmetries in information and loss functions among the contracting parties and the inability of the uninformed to verify the information provided by the informed (Watts, 2003a, 2003b). There is a need for conservatism (i.e., prudence) in financial accounting and reporting because, in the face of the uncertainty of business and economic activities, prudence demands a higher degree of verification for the establishment of recognized assets than of liabilities. Accounting convention should encourage such prudence.

LaFond and Watts (2008), using a U.S. data set, find evidence that information asymmetry is positively related to accounting conservatism and, more importantly, that changes in information asymmetry affect conservatism rather than conservatism driving information asymmetry. They conclude that the roles of accounting conservatism not only relate to debt and compensation contracts, but also cover equity investors. However, the disparate degree of accounting conservatism around the world calls for an investigation into the role of conservatism in different countries.

Three reasons justify why this study follows the method used by LaFond and Watts (2008) and why it uses Taiwanese data to reexamine how information asymmetry is related to conservative accounting. First, it is well known that the degree of accounting conservatism differs across countries and according to preparers' incentives (Ball, Kothari, & Robin, 2000; Ball, Robin, & Wu, 2003; Ball & Shivakumar, 2005). Differences in institutional settings may invalidate the conclusions of LaFond and Watts (2008), which are based only on U.S. data, so research like the present study is needed before their conclusions can be considered generally valid. Thus, it is worth investigating the relation between information asymmetry and accounting conservatism beyond the U.S. data. We will discuss how specific institutional differences may affect the information role of accounting conservatism found in LaFond and Watts (2008) in the next section. Second, the size of the Taiwan stock market, which was the world's twentieth largest during our research period, makes it a significant example of a code-law regime within which to test the information role of conservatism.² Third, this study further investigates the role of auditor tenure. Note that audit-firm tenure (e.g., Gul, Fung, & Jaggi, 2009; Myers, Myers, & Omer, 2003; Stanley & DeZoort, 2007) has been commonly used in auditing research. However, to the best of our knowledge, no studies examine how auditor tenure affects the relation between information asymmetry and accounting conservatism discussed above. Thus, we further incorporate this variable into our analysis. Our findings reveal that auditor tenure affects the relation between information asymmetry and accounting conservatism. Specifically, for a case of good news the relation is *weaker* when the auditor tenure of the

² According to the World Federation of Exchanges (<http://www.world-exchanges.org/files/statistics/>), during our research (2000–2008), the rank of market capitalization of shares of domestic companies in Taiwan ranged from 13th (2000, 2001, and 2003) to 20th (2007).

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