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Does accounting conservatism improve the corporate information environment?☆

Jinshuai Hu[a], Annie Yuansha Li[b], Feida (Frank) Zhang[c,*]

[a] Institute for Financial and Accounting Studies, Xiamen University, Xiamen, Fujian, PR China
[b] Manning School of Business, University of Massachusetts at Lowell, Lowell, MA 01854, United States
[c] School of Management & Governance, Murdoch University, Perth, WA, Australia

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ABSTRACT

This study investigates whether and how accounting conservatism improves the corporate information environment. We argue that conservatism facilitates the flow of firm-specific information from corporate insiders to outsiders and leads to a high-quality information environment. Using the Basu (1997) model to capture the extent of accounting conservatism and firm-specific return variation to proxy for the quality of information environment, we find that conservatism is positively associated with the improvement of the corporate information environment in our sample of 43 countries. We also find that the information role of conservatism is more pronounced in countries with weaker protection of private property rights, suggesting that conservatism substitutes for legal institutions in ensuring the quality of information environment.

1. Introduction

Accounting information helps to reduce information asymmetry among contracting parties and plays a crucial role in capital markets. Existing literature posits that earnings, as the most fundamental accounting information, are of higher quality when they are more conservative, implying that accounting conservatism improves a firm's information environment (e.g., Ball & Shivakumar, 2005; Ball, Kothari, & Robin, 2000; Ball, Robin, & Wu, 2003; Wang, 2006). However, empirical evidence is scant on the relation between accounting conservatism and the quality of the corporate information environment across countries. Drawing on a U.S. sample, LaFond and Watts (2008) provide evidence that information asymmetry between corporate insiders and outside equity investors drives managers to adopt conservative accounting, indicating the information role of conservatism.[1] However, they fail to detect that greater conservatism lowers information asymmetry, and thus do not provide direct evidence to support the information role of conservatism.

We posit that the small variation in accounting conservatism across firms or industries within a given country (i.e., the U.S.) may partially explain why LaFond and Watts (2008) fail to detect the information role of conservatism (Bushman,

☆ *Data availability*: The data are available from the public sources identified in this paper.

* Corresponding author at: School of Management & Governance, Murdoch University, 90 South Street, Murdoch, Perth, WA 6150, Australia.
E-mail addresses: hujs@xmu.edu.cn (J. Hu), Yuansha_Li@uml.edu (A.Y. Li), Frank.Zhang@murdoch.edu.au (F. Zhang).

[1] LaFond and Watts (2008) argue that outside equity investors demand more conservative earnings as a means of mitigating agency problems. They show that changes in information asymmetry between insiders and outside investors lead to changes in accounting conservatism.

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Piotroski, & Smith, 2011). Our cross-country study attempts to fill this research gap by examining the direct relationship between accounting conservatism and the quality of information environment.[2]

Recent research shows that conservative accounting helps to improve contracting efficiency, and acts as a governance mechanism limiting managerial opportunism (e.g., Ahmed, Billings, Morton, & Stanford-Harris, 2002; Holthausen & Watts, 2001; Watts & Zimmerman, 1986; Watts, 2003).[3] Building on this stream of research, we contend that conservative accounting, as part of a firm's disclosure policies, facilitates the flow of firm-specific information from corporate insiders to outsiders. Following Basu (1997), accounting conservatism is defined as asymmetric recognition of economic gains and losses into earnings, and thus equals timeliness of loss recognition (TLR hereafter) minus timeliness of gain recognition (TGR hereafter).

Prior studies suggest that TLR is more important than TGR in determining accounting conservatism and its effects (e.g., Armstrong, Guay, & Weber, 2010; Ball et al., 2000; Basu, 1997; Francis & Martin, 2010). It is expected that managers have economic incentives to voluntarily disclose gains (i.e., good news) and to suppress disclosing losses (i.e., bad news). Financial reporting rules (such as TLR) that commit managers to disclosing bad news in a timely manner facilitate the flow of firm-specific information from corporate insiders to outsiders (Armstrong et al., 2010), and thus enhance firm-specific stock return variation, our measure of corporate information environment.[4] Therefore, we predict that accounting conservatism is positively associated with the quality of the corporate information environment.

Using 130.869 firm-year observations from 43 economies for the 1998–2008 period, our results show that accounting conservatism is positively associated with the quality of the corporate information environment. The association between TLR and the corporate information environment is significantly positive. Results on the association between TGR and the corporate information environment are mixed, indicating that the TLR aspect of accounting conservatism is more important than TGR in facilitating the flow of firm-specific information from insiders to outside investors. Furthermore, we provide evidence that the positive relation between accounting conservatism and corporate information environment is significantly more pronounced in countries with weaker protection of private property rights. Our findings highlight the effective role of conservative accounting as a governance mechanism in enhancing the quality of a corporate information environment. Our results are robust to a battery of sensitivity tests, including alternative models measuring conservatism and corporate information environment, and various proxies for investor protection.

This study contributes to the literature in a number of ways. First, accounting conservatism is an important dimension of the quality of corporate information environment (e.g., Ball & Shivakumar, 2005; Ball et al., 2000, 2003; Wang, 2006). However, to the best of our knowledge, there is no direct evidence to substantiate the information role of accounting conservatism. By documenting a positive association between accounting conservatism and the quality of information environment, our study lends support to the information role of accounting conservatism, and sheds light on recent accounting literature examining the consequences of conservatism.

Second, our study employs an international dataset to explore the effects of accounting conservatism on information environment, an association that is difficult to detect in a single-country setting. Our study extends LaFond and Watts (2008) by demonstrating that accounting conservatism does improve a firm's information environment, and thus helps to explain why information asymmetry could pressure managers to use accounting conservatism.

Third, our study stresses the important governance role of conservatism as a substitute for country-level legal institutions supporting a high-quality information environment. Thus, in order to provide a better corporate information environment, managers can adopt conservative accounting, especially in countries where good property protection institutions are unavailable. The remainder of this paper is organized as follows. Section 2 develops research hypotheses and Section 3 specifies the research design. Section 4 describes data and presents descriptive statistics. Our main empirical results are detailed in Section 5 and Section 6 reports the results of further tests. Section 7 presents robustness checks. Section 8 discusses research implications and limitations, with conclusions provided in Section 9.

2. Hypothesis development

Accounting conservatism triggers the recognition of losses (i.e., bad news) in earnings when they are probable, but defers the recognition of gains (i.e., good news) until they are verifiable. Managers are expected to have economic incentives for voluntarily disclosing gains and suppressing losses. Financial reporting rules such as TLR that commit managers to disclosing bad news in a timely manner result in a more complete disclosure environment that facilitates the flow of

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[2] A growing body of international accounting and finance literature reports that country-level institutions play a first-order role in shaping financial reporting incentives (Ball et al., 2000, 2003; Bushman & Piotroski, 2006; Bushman et al., 2011). Therefore, using an international dataset increases the probability of directly detecting the information role of conservatism.

[3] Watts (2003) and Holthausen and Watts (2001) argue that conservatism helps to address agency problems. Zhang (2008) documents that firms that apply more accounting conservatism experience faster debt covenant violations, thus "triggering the alarm" for borrowers earlier. Moerman (2008) shows that more conditionally conservative firms enjoy lower bid-ask spreads on the secondary loan markets. Ahmed et al. (2002) show that debt-holders view conservatism as a means of minimizing agency problems between debt-holders and shareholders, and thus accounting conservatism is negatively related to cost of debt. Ball et al. (2008) show that conservatism leads underwriters to hold a lower stake in issued loans. Altogether, these studies provide evidence suggesting that conservatism is an effective tool in reducing information asymmetry and monitoring managers' behavior.

[4] Following Fernandes and Ferreira (2008) and others, we use firm-specific return variation to proxy for a firm's information environment. Greater firm-specific return variation indicates more firm-specific information being impounded in stock prices, higher price informativeness, and thus a better information environment (Morck et al., 2000; Jin & Myers, 2006).