

Corporate Governance and Accounting Conservatism in China*

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Abstract

A principal-agent relationship exists among creditors, shareholders and management, and information asymmetry among them leads to asymmetric loss functions, which induces conservative accounting. This paper investigates the determinants of accounting conservatism using accrual-based measures and data from 2001 to 2006 in China. We find that a higher degree of leverage, lower level of control of ultimate shareholders and lower level of management ownership lead to more conservative financial reporting. We also find that political concerns and pressures among state-owned enterprises are greater than those among non-state owned enterprises, which leads to more conservative financial reporting among the former. However, a decrease in such concerns leads to a decrease in accounting conservatism. Overall, we find that among the determinants of conservatism in China, debt is the most important, followed by ownership, and that board has little influence.

JEL classification: G30; M41

Keywords: Information asymmetry; Agency problem; Accounting conservatism; Political concerns; Corporate governance

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1. Introduction

Conservatism is an important and basic principle in financial accounting. It stipulates that possible errors in measurement should be in the direction of understatement rather than overstatement of net income and net assets. If two estimates of earnings or assets to be received or paid in the future are approximately equally likely, then conservatism dictates that the less optimistic one be used (Statement of Financial Accounting Concepts No. 2, FASB).¹ Under conservative accounting, the average market value is higher than the book value in the long run (Feltham and Ohlson, 1995; Zhang, 2000; Beaver and Ryan, 2000; Penman and Zhang, 2002). Such accounting recognizes bad news in a more timely way than it does good news, leading to asymmetric timeliness of earnings (Basu, 1997; Ball *et al.*, 2000; Givoly and Hayn, 2000; Holthausen and Watts, 2001; Ball *et al.*, 2003; Watts, 2003a). This type of conservatism is also known as conditional conservatism (Beaver and Ryan, 2005).² Conservatism is beneficial for creditors,³ minority stockholders,⁴ the whole firm⁵ and regulatory authorities⁶ (Ahmed *et al.*, 2002; Watts, 2003a; Francis *et al.*, 2004; Nikolave, 2006; Ahmed and Duellman, 2007; Zhang, 2008).

Watts (2003a) proposes that one factor influencing accounting conservatism is regulations. He argues that standard setting authorities may face political pressure and public criticism. To reduce their political costs and protect the interests of investors, these authorities prefer conservative accounting (Bushman and Piotroski, 2006). However, Ball *et al.* (2003) contend that management incentives have a greater influence on financial reporting policies than have other factors. In China, managers face pressure from the government. This affects their political future and is thus likely to be

¹ However, if the two estimates are not equally likely, conservatism does not necessarily dictate using the more pessimistic one rather than the more likely one. Conservatism no longer requires deferring recognition of income beyond the time that adequate evidence of its existence becomes available or justifies recognizing losses before there is adequate evidence that they have been incurred (Statement of Financial Accounting Concepts No. 2, FASB).

² Conditional conservatism (Beaver and Ryan, 2005) or ex-post conservatism (Richardson and Tinaikar, 2004), also called news dependent conservatism (Chandra *et al.*, 2004) and asymmetric income timeliness (Basu, 1997), implies more timely earnings recognition of bad than good news. Unconditional conservatism (Beaver and Ryan, 2005) or ex-ante conservatism (Richardson and Tinaikar, 2004), also called news-independent conservatism (Chandra *et al.*, 2004), stems from the application of generally accepted accounting principles (GAAP) or policies that reduce earnings independent of current economic news.

³ Conservatism can protect the interests of creditors, providing creditors with new information to react to contract violations and enforce in a timely fashion their contractual rights, such as limiting the leverage, investment or dividend policy.

⁴ Conservatism can be beneficial for minority shareholders as it can reduce the amount of inefficient capital investment, restricting the power of management.

⁵ Conservatism can reduce the level of information asymmetry between creditors and shareholders, lowering financing costs.

⁶ Conservatism can reduce the level of pressure and criticism from the public due to the standards that regulatory authorities have set.

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