

# Accounting conservatism and risk taking decisions



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## Introduction

Manager is in a position of Captain in Charge in ship of the Organization, so that to make organization more beautiful Manager has duty to make an important decision on Corporate Investment. These types of decisions create Agency Problems because of the time interest differences between manager and shareholder. This research is carried out to understand how conservatism accounting reduces agency problems, and examines the effect of conservatism on manager's high risk investment decision. This research also examine that whether accounting conservatism solves the misalignment of interest between managers and organization through increasing hurdle rates used by managers during project selections, and sheds lights on literature attempting to identify the relation between accounting conservatism and manager's investment decisions.

## Motivation

A study was conducted by Givoly and Hayn (2000), Beatty et al. (2008), and Khan and Watts in 2009, to measure accounting conservatism and firm's characteristics such as size, leverage, and market-to-book ratio. They found evidences to support their hypothesis that accounting conservatism improves firms' investment efficiency. According to Khan and Watts managers' investment hurdle rates and induces conservative investment decisions are significantly increase under conservatism accounting, even when the agency problems are more severe this effect is more pronounced.

According to the positive accounting theory accounting conservatism plays very effective role in the roll contracting process. Corporate investment is an

important decision, but this decision are not always made in the best interest of shareholders, so many time manager invest in a risky and even negative net present value projects just because of their personal interest in of investment. Accounting conservatism is a reporting mechanism which reflects accountant's trend to require lower threshold to recognise bad news than good news. Accounting conservatism helps to improve corporate investment by preventing investment in high risk or unsuccessful investment projects by early terminations of such projects. This early terminations of projects reduces managers compensation and increases managers interest of job turnover. If manager is rational to predict the accelerated recognition of losses, and the timely termination of unsuccessful projects, they will be more cautious to make the investment decisions. (Francis and Martin (2010) and Bushman et al. (2007)) The increased cautiousness to invest will be reflected in the hurdle rate, which used to evaluate an investment project. In theory, hurdle rate is as equals as the cost of capital; managers should not take decision to invest in a project if the return is lower than the cost of financing. Indeed hurdle rate is observed to be either lowers than the cost of capital in practice, because of managerial discretion.

The result of the study state that Corporate governance role have established the roll of accounting conservatism in resolving information asymmetry, reducing agency costs, and improving debt contracting efficiency. (Ball (2001), Ball and Shivakumar (2005))

Literature Review

There are many research has been carried out in about the relation of the accounting conservatism and manager's risk taking decision. Ahmed and Zhang, 2009 found that accounting conservatism reduces information imbalance between lenders and borrowers, and also reduces cost of capital for borrowers. They also found that if conservatism cause financially constrained firms to under investment than the relation between conservatism and firm's future performance will negative. On the other hand reduce overinvestment problem for financially constrained firms, than the relation will be expected positive.

Another research carried out by Leuz (2001) and Guay and Vierrecchia (2006) and found that accounting conservatism force manager to avoid positive NPV projects, because Impaired incentives created for managers if gains not recognize timely untimely gain recognition, and manager force to avoid those types of positive projects. In particular, if gains are not recognize timely than manager will responsible for investment for those project, and may no longer be in the office by the time gains are realized. This is because always expect their future incentive rate higher in long term, than the firms required rate of return. If gains recognise by timely than even positive NPV for shareholder became negative for manager.

Accounting conservatism increases corporate investment efficiency in two ways. First is, by timelier incorporating bad news into earnings, accounting conservatism inform the board's investigation of the unsuccessful investment project that may lead to its early abandonment, saving shareholders from unexpected future losses (Watts 2003). On the other hand, the expected personal costs related to project such as compensation, <https://assignbuster.com/accounting-conservatism-and-risk-taking-decisions/>

reputation and career concerns would increase managers' cautiousness in choosing investment projects at the outset.

Extant studies by Ball and Shivakumar, 2005; Francis and Martin, 2010 believe that accounting conservatism can restrain managers to investing in negative NPV projects by accelerated loss recognition. In addition, if managers recognise ex ante about failure of particular project, they should record losses timely, because it will affect to their reputation and income as well, so manager should postpone investing in those project.

Furthermore, Roychowdhury (2010) found that risky projects are mostly become negative projects, therefor managers try to avoid risky projects due to timely loss recognition, because it creates also risk-averse, even if the projects have profitability to shareholders. If managers know that the project is have many risks of failure, manager have to write losses more timely before failure of project, because manager's reputation income linked with compensation will be affected by it, so that manager avoid to involve to invest in those projects, even though projects are profitable.

Smith and Watts 1992; Kwon and Yin 2006 found that, firms with higher growth opportunities prefer to assets have higher contracting costs, because growth opportunities are often intangible in nature, so that information related to them are likely less verifiable. Therefore, managers have greater unrestricted power, and are more likely to manage earnings through accruals, so that agency costs are higher in high-growth firms. Furthermore high growth firms are more likely to have more volatile returns and higher probability of lawsuits, which creates a higher demand of accounting

conservatism (Khan and Watts, 2009). Empirically, we use book-to-market ratio (an inverse measure of growth opportunity) to measure the growth opportunity of firms.

Driver and Temple (2010) found that, if the manager is aware of the embedded risk a hurdle rate that is higher than the cost of capital will be used by the irreversibility of the investment project. Corporate investment is efficient in the situation where internal funds flow gives the highest returns from investment project. However, managers deviate from the optimal level of investment, because of dysfunctional investment incentives (Stein et al. 2003). These dysfunctional incentives can be reflected in the hurdle rates used to select projects. Finance textbooks state that managers should benchmark the investment return to the cost of capital, so that with the project with lower returns than the cost of capital are rejected. In addition, managers use hurdle rates which sometimes higher or lower against the cost of capital, it depends on the managerial incentives invest.

Consistent with Hayn (2000), and Watts (2003), They found that both not only firm with goodwill purchased but also without goodwill have increasing trend in conservatism over time. Indeed He argue that lach of information will limit managers to random affect to recognize impairment losses agains their advantage timely.

The following hypotheses are proposed for this study:

H1 Accounting conservatism improves firms' investment efficiency.

H2 Accounting conservatism helps manager to recognize bad news timely.

H3 Accounting conservatism accelerates terminations of successful projects.

H4 Accounting conservatism can restrain managers to investing in negative NPV projects by accelerated loss recognition.

To test hypotheses Basu's (1997) used measure of conditional conservatism, because of the verification standards of the hypotheses of recognizing bad news and good news assumptions. (Richardson, 2006; Denis and Sibikov, 2010) they also examine relation between accounting conservatism with the component of investments by using total investments and changes in firm capital.

This study concluded that accounting conservatism is an important monitoring and contracting mechanism, and it helps manager to recognize bad news timely, so that manager could increase their managerial interest regarding project. Indeed accounting conservatism accelerates terminations of unsuccessful projects, also study found that conservative accounting increases hurdle rates, in addition conservatism changes hurdle rate because it reduces the future financial cost rather than by increasing the efficiency of contracting with the managers. We also find conservatism adds value to firms. This study also sheds light on relation between accounting conservatism and managers' investment decisions. The study also shows that the accounting conservatism negatively correlates investment and firms future operating performance.