

The Joint Effects of Monitoring and Incentive Alignment on Accounting Conservatism

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Abstract

This paper investigates the joint impact of strong corporate governance and incentive alignment on accounting conservatism. Prior research has found that the higher the monitoring by the board, the higher the accounting conservatism (Garcia Lara et al., 2009). Prior research has also found that when the incentive alignment is high, the observed accounting conservatism in financial reports is low and redundant (Lafond and Roychowdhury, 2008). This paper looks at the joint effects of these two countervailing forces of monitoring and the incentive alignment on conservatism and finds that the observed conservatism is high when both are present, thus suggesting that high corporate governance is a dominant and omitted variable which alters the relationship between the incentive role of corporate governance and conservatism. The findings suggest that selective strengthening of corporate governance and selective conservative reporting for low incentive aligned firms provide an even more effective option for managing agency conflicts. Further, these findings are relevant to the FASB's debates on when and whether standards need to be conservative versus neutral.

Keywords: Incentive alignment, Monitoring role of corporate governance and accounting conservatism

1. Introduction

The separation of ownership from control and its consequent agency problems give rise to demand for a variety of incentive and monitoring mechanisms by stakeholders of firms to ensure that managers act in their (stakeholders) best interests (Fama and Jensen, 1983). Examples include corporate governance by a board of directors, well-structured incentive compensation contracts, internal control systems, and external auditing. Yet, corporate scandals such as those involving Enron, WorldCom, Waste Management and many others point to inadequacies in these mechanisms, and have prompted regulators to enact the Sarbanes-Oxley (SOX) Act of 2002 which seeks to strengthen corporate governance and auditor independence, and hold corporate chieftains responsible for what they do and what they say.

Financial reporting plays a fundamental and critical role in this context because financial reports serve as a primary source of information for outside stakeholders, both for firm valuation (the valuation role) and for evaluating managerial performance (stewardship role). While corporate governance via the board of directors, incentive contracting, and independent external verification by auditors have evolved as organizational responses to the problems of separation of ownership from control, research also indicates that financial reporting conservatism serves as a safeguard against opportunistic behavior of managers (Watts 2003; Basu 1997; Lafond and Roychowdhury, 2008).

Prior papers have tested and found that the observed accounting conservatism is higher when the enforcement of corporate governance is also aggressive (Garcia Lara et al., 2009). Separately, Lafond and Roychowdhury (2008) tested the relationship between incentive alignment and conservatism; they found that higher incentive alignment is associated with lower observed accounting conservatism. In other words, when there is good incentive alignment, the demand for conservatism accounting is reduced.

While the above results speak to the independent, but seemingly countervailing effects of corporate governance and incentive alignment on conservatism, it is important to raise the question of what would happen if there is both strong corporate governance and high incentive alignment? This is not an unlikely scenario; after all it is to be expected that more than one approach is employed by the board to address the agency problems. This multi-pronged approach likely aligns incentives better, because one approach may not end up eliminating all agency costs. The contracts are seldom

complete and thus significant control rights are still with managers. The board may anticipate that managers may expropriate shareholders by entrenching themselves (Garcia Lara et al, 2009; Shleifer and Vishny, 1997) and therefore accounting conservatism is enforced in conjunction with high incentive alignment to achieve shareholder value. Further, contracts are based on stock performance which is based on accounting numbers. When managers are given significant share ownership to align incentives, the board of directors maybe worried about the possibility of aggressive accounting by managers who may artificially inflate the accounting numbers. To address this potential problem, the board simultaneously implements strong governance mechanisms. Thus, more broadly, it is important to examine the joint implications of enforcement and incentive alignment. This is the focus of the paper.

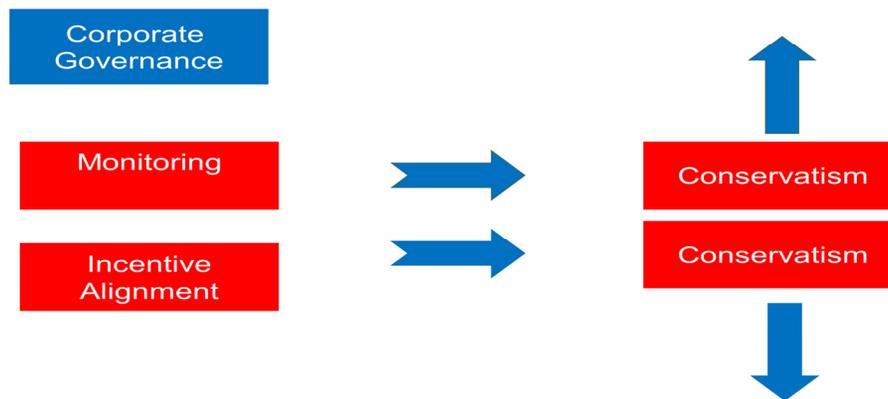


Figure 1. Among these two countervailing forces, which one is more prevalent?

I find that when corporate governance is enforced strongly, and when incentive alignment is high, managers from high incentive alignment firms report their results more conservatively than the low incentive alignment firms. In other words, strong corporate governance is the dominant effect which *subsumes* the countervailing effect of high incentive alignment.

Interestingly, in the presence of strong corporate governance, I find that managers from firms with low incentive alignment adopt some degree of conservatism, but as the level of incentive alignment increases, the level of conservatism adopted increases significantly. This result is consistent with the notion that highly incentive aligned managers will adopt the overall principles laid out by their board relatively more efficiently than the low incentive aligned managers.

Prior literature has established that firms adopt *less* conservatism when incentives are highly aligned (Lafond and Roychowdhury, 2008). Adding to this literature, I find that when these firms are subjected to strong corporate governance, high incentive alignment firms report their result *more* conservatively than the less incentive aligned firms. This result is consistent with the notion that some boards enforce accounting conservatism *even on highly incentive aligned managers* to ensure that key managers operate effectively without personal expropriation.

There has been considerable focus in the accounting and finance literatures on the functioning of different corporate governance mechanisms such as incentives and the composition of the board of directors, the efficacy of internal control mechanisms, and the quality and independence of external auditors (Shleifer & Vishny, 1997; Denis, 2001). A sizeable literature is also emerging in accounting on understanding and measuring different facets of conservatism and its implications for financial reporting (Basu 1997; Beaver and Ryan, 2005; Ball and Shivakumar, 2006; Ball et al., 2000 and 2012; Ryan, 2006). However, to the best of my knowledge, there is little research on how observed conservatism is impacted by the joint effects of monitoring and high incentive alignment in firms. This paper examines this crucial link and shows that the impact of the monitoring role of corporate governance on conservatism alters the

direction of the difference in conservatism between high incentive alignment and low incentive alignment firms by relatively increasing the level of conservatism among the high incentive aligned firms.

Understanding this link between incentive alignment, monitoring and conservatism can help us better understand managerial reporting behavior under important circumstances. I posit and find that the monitoring and the contracting roles of corporate governance have different implications for the degree of conservatism we might find in financial statements. Prior literature points to an interesting reason for this. Consider the contracting role, i.e., the case where corporate governance is effective in aligning incentives (relatively speaking) and managers are supposedly acting in the best interests of shareholders. In this case, managerial opportunism is not an issue, and therefore conservatism has a relatively lower role in countering managerial opportunism (Lafond and Watts, 2008). If, on the other hand, corporate governance is geared more toward enforcement (Note 1) i.e., instituting *stronger reporting controls*, then we should expect firms to adhere to the spirit of the conservatism principle more faithfully, and we should observe a higher degree of conservatism in financial reports, as indeed Garcia Lara et al. (2009) argue. However, ex-ante, the board of directors will not know the extent to which incentives are aligned and therefore are likely to have more than one method to maximize shareholder value.

2. Background and Hypothesis Development

It is well established that the separation of ownership and control in modern organizations leads to agency problems (Berle and Means 1932; Fama and Jensen 1983). Corporate governance, financial reporting conservatism, and other incentive mechanisms such as executive compensation (Coughlan and Schmit, 2002; Watts and Zimmerman, 1986) are some examples of methods that have been used to address these agency conflicts. Other research examines the interrelationships between corporate governance and financial reporting principles, as both address agency conflicts (e.g., Beekes et al. 2004; Ahmed and Duellman 2007; Garcia Lara et al. 2009) and finds that strong corporate governance complements conservatism in addressing agency problems. Extant literature has also studied the interrelationship between corporate governance and earnings management. For example, Beasley, 1996; Peasnell, 2005; and Bowen et al. 2008 find that firms with a higher proportion of independent directors have lower earnings management.

Interestingly, recent research suggests that strength of corporate governance is different from the effectiveness of corporate governance evidenced through managerial ownership (Lafond and Roychowdhury, 2008 and Garcia Lara et al., 2009).

While corporate governance is an institutional mechanism, a widespread accounting principle that has evolved as a way to protect investors from opportunistic (income increasing) behavior of managers is the principle of conservatism (Watts, 2003). In its extreme form, conservatism results in anticipation of all losses, but no anticipation of profits (Bliss, 1924). Basu (1997) develops a measure of conditional conservatism, the manager's tendency to be cautious and recognize uncertain losses compared to gains. This differential or asymmetric treatment for gains versus losses is evidence of conservatism, per Basu (1997).

In the recent past, FASB and other standard setting organizations have questioned the need for the existence of a conservative bent in standards. For example, Accounting Research Bulletin (ARB) 2 states that, "Conservatism in the balance sheet is of dubious value if attained at the expense of conservatism in the income statement".

In the absence of any agency conflicts, it would seem that financial reports are intended to convey relevant information in a fair and in particular, *unbiased*, manner. Healy and Palepu (2007) state that in an *ideal* world, unbiased information is better than biased information. Clearly, it is the agency conflict and the consequent (potential) opportunistic behavior of managers that is arguably one reason for the conservative bent in standards. This paper shows that although there is lesser need for conservatism when agency costs are low, when high monitoring is also simultaneously imposed on the highly incentive aligned group, we can observe conservatism in their financial reports. Thus, high monitoring results in the adoption of conservatism where it is perhaps not necessary. This is the unique finding of this paper which has implications for standard-setting and debates on the cost-benefits of conservatism.

Furthermore, recent thinking among standard setters internationally is that neutrality or unbiased information is better than biased information, since biased information is not objectively prepared (Wiecek and Young, 2009). I argue that conservatism is costly under certain conditions, namely when the agency costs are low. However, the benefits from conservatism occur when agency costs are high (Watts, 2003).

Interestingly, a recent body of literature argues that the demand for conservatism does not arise from investors but from debt contracting (Beatty et al., 2008, Ball et al., 2007 and Zhang, 2008). Lafond and Roychowdhury (2008) while examining the relationship between managerial ownership and conservatism discuss the debt hypothesis put forth by

Ball et al. (2008) and show that conservatism driven by equity investors exists even after controlling for financial leverage. Thus it is far from clear whether one and only one set of stakeholders drives the demand for conservatism. In fact, Lafond and Watts (2008) and Lafond and Roychowdhury (2008) present evidence that a move away from conservatism will likely reduce the usefulness of accounting numbers in addressing the issue of agency conflicts between managers and shareholders.

Corporate governance mechanisms and conservatism are two aspects of the modern corporation that serve the purpose of addressing the agency problem, although the first is an institutional mechanism while the second is an accounting principle. In this paper, I posit that the strength of corporate governance as measured by the Totgov index (also known as the monitoring role of corporate governance) is different from the contracting role of corporate governance (when incentives are aligned) and therefore hypothesize that the presence of strong corporate governance alters the relationship between incentive alignment and accounting conservatism. Notice that the monitoring role of corporate governance exerts its own influence on conservatism, and thus the hypothesis sets up a horse race between incentive alignment and the monitoring role of conservatism and can be written as:

Hypothesis: Strong corporate governance will lead to an increase in conservatism among high incentive aligned firms compared to low incentive aligned firms.

3. Variable Measurement and Research Methodology

Garcia Lara et al. (2009) introduce a measure called total governance (Totgov Index) which has several components to measure external and internal board characteristics. I use this measure to operationalize the monitoring role of corporate governance because recent research suggests that the Gompers Index, when used as a *sole* proxy, may not be an accurate indicator of the strength of corporate governance (Holmstrom and Kaplan, 2001, Core, Guay, Rusticus, 2006, Brown and Caylor, 2006). This is because internal governance also has to be taken into consideration while computing strength of corporate governance. The findings of Cremers and Nair (2005) also support this notion that strength of corporate governance arises from both external and internal governance. Additionally, in a recent review, Brown et al. (2011) point to the need for use of corporate governance indices which reflect the broad scope of governance (internal and external). Therefore in this paper, I also use percentage of independent board members, inverse of number of board meetings (Note 2) and CEO duality to proxy for internal governance and combine it with Gompers Index as a measure for external governance to make a Totgov Index along the lines of Garcia Lara et al. (2009).

Several studies use proxies of managerial ownership to capture the notion of incentive alignment (Lafond and Roychowdhury, 2008). Managers with high ownership typically have longer horizons leading to higher firm value (Jensen and Meckling, 1976). Morck, Shleifer and Vishny, 1988 also point out that managerial ownership is an effective way to align the interest of the managers to those of the shareholders. Following these papers, I use the percentage of share ownership of CEO excluding options (henceforth Perctshown) as a proxy for the level of incentive alignment. Lafond and Roychowdhury (2008) operationalize incentive alignment by using managerial ownership of the CEO and another second measure, using the percentage ownership of key managers including the CEO. The second measure suggests that higher the managerial ownership of key personnel in the firm, the higher the incentive alignment and lower the agency conflict. Compared to testing the level of incentive alignment by using only the level of CEO ownership, I use the managerial ownership which includes the top managers and the CEOs. This measure is more appropriate because these managers are the likely key decision makers regarding level of conditional conservatism recognized in the books and in decisions regarding implementation of decisions as enforced by the board (strong corporate governance).

I do not include the stock options in the measure for incentive alignment, following Lafond and Roychowdhury's (2008) main variable used as a proxy for managerial ownership. This is because current shareholding represents short-term alignment, whereas option holding reflects longer-term alignment, since options cannot be converted to cash right away as shares do. In future research, this could be an interesting angle to pursue, i.e., examine whether the degree of conservatism would change between short- and long-term alignment, and how stronger monitoring would affect the relation. It is possible that using the current measure for short-term alignment, monitoring serves to increase conservatism (which is the finding in this paper). In contrast, when managers' incentives are aligned with long-term firm value by holding options, the need for stronger monitoring could be observed as less.

I use the following Basu (1997) model to test conservatism.

$$E_{it}/P_{it-1} = \alpha + \beta_1 D_{it} + \beta_2 RET_{it} + \beta_3 (RET_{it} \times D_{it}) + \varepsilon_{it} \quad (1)$$

where,

i = firm and t = time; E = Earnings = Data58; P = Price = Data199; RET = 12-month Return starting from the fourth month after the end of the previous fiscal year (Givoly and Palmon, 1982; Easton and Harris, 1991; Basu, 1997); D = Dummy Variable which equals 1 when Returns is negative and 0 otherwise. Therefore a positive and significant , the interaction of the Returns with is evidence of conditional conservatism in the system, per Basu (1997).

The Basu model (1997) has been criticized on some counts in papers such as Givoly, Hayn and Natrajan (2007), who point out that the results from the Basu (1997) model arise due to characteristics in the information environment and not due to the existence of true conservatism. Further Dietrich et al. (2007) find evidence of Sample Variation (SV) and Sample Truncation (ST) bias in the model. Per the findings, these econometric biases lend the results from the Basu (1997) model unstable. More recently, Patatoukas and Thomas (2011) showed some problems with the model through a series of tests. Although such criticisms exist, it is important to note that in my partitioning of the sample, I study conditional conservatism across high and low monitoring, and high and low incentive alignment. I have no reason to believe that the biases identified in these papers will impact the results across such partitions in any systematic way.

Next, to test and reconfirm that the degree of conservatism is increasing in the level of enforcement, I use the following model:

$$E_{it}/P_{it-1} = \alpha + \beta_1 D_{it} + \beta_2 RET_{it} + \beta_3 (RET_{it} \times D_{it}) + \beta_4 SCG_{it} + \beta_5 D_{it} * SCG_{it} + \beta_6 RET_{it} * SCG_{it} + \beta_7 (RET_{it} \times D_{it}) * SCG_{it} + \varepsilon_{it} \quad (2)$$

Second, I confirm that the degree of conservatism is decreasing in the extent of incentive alignment, regardless of the strength of corporate governance (Lafond and Roychowdhury, 2008). Thus, as a starting point I re-establish that when there is higher incentive alignment, firms report less conservatively.

$$E_{it}/P_{it-1} = \alpha + \beta_1 D_{it} + \beta_2 RET_{it} + \beta_3 (RET_{it} \times D_{it}) + \beta_4 PERCENTSHOWN_{it} + \beta_5 (D_{it} * RET_{it}) * PERCENTSHOWN_{it} + \beta_6 D_{it} * PERCENTSHOWN_{it} + \beta_7 RET_{it} * PERCENTSHOWN_{it} + \varepsilon_{it} \quad (3)$$

Next, I discuss the regression analyses conducted to test this hypothesis.

$PERCENTSHOWN_{it}$ is a dummy variable that equals 1 if the past industry adjusted $PERCENTSHOWN_{it}$ is greater than the median and 0 otherwise.

P = Price = Data199; RET = 12-month Return starting from the fourth month after the end of the previous fiscal year; D = Dummy variable which takes the value of 1 if the Return is negative;

Therefore a negative and significant β_5 , which is the interaction of $D_{it} \times RET_{it}$ with $PERCENTSHOWN_{it}$ indicates that the level of conservatism is significantly lower when the agency problem is less severe.

My principal *main* hypothesis tests whether the level of conservatism is higher for firms with high incentive alignment compared to low incentive alignment in the presence of strong corporate governance. To test this, I use the coefficients from the following equation.

$$E_{it}/P_{it-1} = \alpha + \beta_1 D_{it} + \beta_2 RET_{it} + \beta_3 (RET_{it} \times D_{it}) + \beta_4 PERCENTSHOWN_{it} + \beta_5 (D_{it} \times RET_{it}) * PERCENTSHOWN_{it} + \beta_6 SCG_{it} + \beta_7 D_{it} * PERCENTSHOWN_{it} + \beta_8 (RET_{it} \times D_{it}) * SCG_{it} + \beta_9 D_{it} * SCG_{it} + \beta_{10} RET_{it} * SCG_{it} * PERCENTSHOWN_{it} + \beta_{11} RET_{it} * SCG_{it} + \beta_{12} RET_{it} * PERCENTSHOWN_{it} + \beta_{13} D_{it} * PERCENTSHOWN_{it} * SCG_{it} + \beta_{14} PERCENTSHOWN_{it} * SCG_{it} + \beta_{15} (D_{it} * RET_{it}) * SCG_{it} * PERCENTSHOWN_{it} + \text{controls} + \varepsilon_{it} \quad (4)$$

4. Empirical Results

4.1 Data and Sample Selection

My data pertains to the sample period 1997-2005 because internal governance variables are available only from 1997 in the IRRC database. Second, the IRRC database was acquired by ISS Governance services, a part of Risk Metrics, in 2005. Shortly thereafter, Risk Metrics *stopped* collecting and providing some internal governance variables. Since this paper operationalizes internal governance using the Total Governance Index (External + Internal Governance variables) following the Garcia Lara et al (2009) methodology, there is *no data* available in Risk Metrics to measure Totgov beyond 2005. Therefore, the sample period for this paper ends in 2005. I use the following criteria for a firm to be included in the sample of firms:

- 1) The firm should have a valid Governance Index (GI) score (taken from Professor Metrick's website). (Note 3)
- 2) The firm should have all the relevant information in the Standard and Poor's COMPUSTAT Merged Annual Industrial Research file for the sample period in order to compute ROE information and information pertaining to the descriptive statistics for computation of the incentive alignment variables, to compute the descriptive statistics.
- 3) Monthly returns data should be available in CRSP (Center for Research in Security Prices) for the sample period 1997-2005. This is required to calculate the buy and hold returns which is used as a proxy for news in Basu's (1997) conservatism equation.
- 4) The firm should have information on number of board meetings, CEO duality and proportion of independent directors in the Investor Responsibility and Research Center (IRRC) database.
- 5) I truncate observations above the 99% and below the 1% level for earnings and returns. This is in accordance with prior literature.

The above criteria lead to a total number of 4002 firm year observations and 924 firms. Table 1 gives the details of the sample screening procedure and the final sample. I begin with 4002 observations at the intersection of COMPUSTAT and CRSP, IRRC (Board Data) and Gompers Index. The main reason for this reduced number is non-availability of all components of 4002 observations comprise the uniform dataset which is used for all my analyses.

Table 1. Sample Selection Procedure

Step	Details of Selection	# of Obs.
1	Firm year observations in IRRC datasets (board data). Available from 1997 to 2006 except for 2001.	11,323
2	Firm year observations at the intersection of COMPUSTAT and CRSP – between 1997 and 2006 – after deleting firms without one-on-one match of GVKEY and PERMNO.	36,994
3	Firm year observations with Gompers Index data for 1998, 2000, 2002, 2003, 2004 and 2005 (before repopulating GI for missing years).	9,574
4	Firm year observations at the intersection of 1, 2, 3 as above (Gompers Index data is missing for some years i.e. 1997 and 1999). I have repopulated the sample using the prior year*	11,173
5	Firm year observations at the intersection of 1, 2, 3 and where board data is available with respect to all four components of Totgov (prop, numbdmtgs, sepchr, GI)	4002
6	Number of firms at the intersection of 1,2, 3, 4 and 5 and where data for percentage share ownership is available according to the Lafond and Roychowdhury (2008) model.	1428

* This is in accordance with prior literature on Gompers Index.

4.2 Descriptive Statistics

I highlight the sample composition by year in Table 2. Notice that the sample composition in 1999 is less than 10% of the overall sample and the sample composition in 2004 is nearly 20% of the overall sample. However, I do not have any reason to expect this sample distribution in 1999 and 2004 to systematically bias the findings in terms of the main hypotheses. The strong economic environment in 1999 stimulated high performance and aggressive reporting and there is a lower representation of such a group of firms in the overall firm mix. In 2004, in the post-SOX era, there is reason to believe that firms adhered to conservative reporting standards (Zhou and Lobo, 2007) and therefore a higher representation of firms in 2004 could have biased this finding to some extent. However, a similar sample period (1994-2004) was used by Lafond and Roychowdhury (2008) and yet they observed a lower level of conditional conservatism among HIA firms. My study also replicates this result. Therefore, there is no reason to believe that the main finding is based on the higher number of observations in 2004.

Table 2. Sample Composition By Year

Year	Frequenc y	Percent	Cumulative frequency	Cumulative Percent
1997	79	5.53	79	5.53
1998	142	9.94	221	15.48
1999	90	6.3	311	21.78
2000	186	13.03	497	34.8
2002	245	17.16	742	51.96
2003	173	12.11	915	64.08
2004	323	22.62	1238	86.69
2005	190	13.31	1428	100

In Table 2a, I present the sample composition by industry. Notice that the durable manufacturers have a 29% representation in the overall sample. This is consistent with the overall COMPUSTAT database. Furthermore, I do not have any prior reason to expect durable manufacturing firms to have higher incentive alignment or lower conditional conservatism or the association thereof.

Table 2a. Sample Composition by Industry*

Industry	Frequency	Cumulative Frequency	Percent	Cumulative Percent
Mining and Construction	10	10	0.7	0.7
Food	46	56	3.22	3.56
Textile and Printing/Publishing	133	189	9.31	13.24
Chemicals	56	245	3.92	17.16
Pharmaceuticals	53	298	3.71	20.87
Extractive	63	361	4.41	25.28
Durable Manufacturers	408	769	25.87	53.85
Computers	124	893	8.68	62.54
Transportation	107	1000	7.49	70.03
Utilities	54	1054	3.78	73.81
Retail	122	1176	8.54	82.35
Financial sector	130	1306	9.1	91.46
Services	111	1417	7.77	99.23
Other	11	1428	0.77	100

*Per Barth, Cram and Nelson, 2001

I present the descriptive statistics for the overall sample in Table 3. It is important to note that these results on the descriptive statistics are consistent with the descriptive statistics of Garcia Lara et al. (2009). This validates the sample in terms of an important prior study in this field, which is the starting point for my analysis. Note that I report the governance variables before they are standardized.

The overall sample has a mean and median market-to-book ratio of 3.34 and 2.26 respectively. The mean Return on Equity is 3.4% and the median is 5.8%. The mean and median Leverage is 0.78% and 0.45%. Size, computed as log of sales, has a mean of 7.26. The mean and median Earnings/Beginning Price is 0.048 and 0.05 respectively; these means and medians closely match those of Garcia Lara et al. (2009).

Table 3. Descriptive Statistics for Key Variables (Full Sample)

Variable	N	Mean	Std. Deviation	Median
	1428	0.048	0.037	0.05
Return	1428	0.1	0.327	0.078
D_Ret	1428	-0.09	0.139	0
SCG	1428	0.31	2.08	0.14
Perctshow n	1428	0.44	0.497	0
Leverage	1428	0.78	2.36	0.45
Size	1428	7.26	1.26	7.08
ROE	1428	14.14	24	12.18
Mtb	1428	3.343	11.217	2.26

Variable Definitions for Table 3

Earnings = Annual earnings per share (Annual COMPUSTAT Data 58)

Pre-managed Earnings = Annual earnings per share (Annual COMPUSTAT Data 58) – Discretionary Accruals (I estimate the discretionary accruals using the Dechow, Richardson and Tuna, 2003 method).

Return = 12-month return starting from the fourth month after the end of the previous fiscal year.

SCG = Totgov Index = Standardized Total Governance Index consisting of four factors which are Gompers Index, percentage of independent board members, inverse of number of board meetings and CEO duality.

Sepchr = Takes the value of 1 if CEO is also the chair of the board and 0 otherwise.

nG = nG stands for Gompers Index which is the anti-takeover index developed by Gompers et al. (2003). A higher value of the index is associated with lower takeover vulnerability and weaker corporate governance.

NUMBDMTG_INV= Inverse of the number of board meetings. A higher value of this index is associated with lower board effectiveness.

Prop = Proportion of independent directors. A higher proportion is associated with stonger governance.

Leverage = Total debt / Equity = Annual COMPUSTAT (Data 34 + Data 9 / Data 60)

Size = Logarithm of Sales = Log (Data 12)

ROA = Net Income / Total Assets = Data 172 / Data 6

MTB = (Common Shares Outstanding * Price) / Total Common Equity =
Annual COMPUSTAT (Data 25*Data 199)/ Data 60

Depvar (Dependent Variable) = Annual earnings per share (Annual COMPUSTAT Data 58) / Price at the beginning of the year (Annual COMPUSTAT Data 199).

4.3 Main Result

I begin the analysis by replicating the Basu model (1997) as specified in Equation 1 for the sample period, 1997-2005. In untabulated results, I am able to find evidence of the existence of system conservatism in a cross-sectional regression, with $\beta_3 = 0.17$, which is positive and significant, $t\text{-value} = 6.43$ and $p\text{-value} < 0.001$.

Next, I replicate the Garcia Lara et al. (2009) study and reaffirm that the degree of conservatism is increasing in the level of High Corporate Governance (Enforcement). $D_Ret + D_Ret_SCG > D_Ret$ ($0.216 > 0.131$), $F\text{-value of difference} = 0.03$ (untabulated results).

Further, I confirm that the degree of conservatism is decreasing in the extent of incentive alignment, regardless of the strength of corporate governance (Lafond and Roychowdhury, 2008). $D_Ret_Perctshown$ is -0.04 , $t\text{-value} = -1.72$, $p\text{-value} 0.08$. Thus, as a starting point, I re-establish that as the level of incentive alignment increases from low to high, firms report less conservatively.

Next, I discuss the main result of the paper, which is the key contribution. The results provide evidence that in the presence of strong corporate governance, the degree of conservatism for firms with high incentive alignment is higher than for firms with low incentive alignment. Thus, in the Lafond and Roychowdhury (2008) model, we can look at the monitoring role as an omitted variable.

In order to present the main results, I classify the sample into four subsamples based on High versus Low Incentive Alignment and Strong versus Weak Corporate Governance. Second, I use the subsample with Strong Corporate Governance and *within* this sub-sample test if the difference in conservatism between HIA and LIA firms is positive and significant. This would be indicative of strong corporate governance impacting the direction of the difference between high incentive alignment and low incentive alignment firms, and would be consistent with the main hypothesis testing the joint effects of incentive alignment and strong corporate governance on conservatism.

	SCG	LCG
HIA	$D_Ret + D_Ret_Perctshown + D_Ret_SCG + D_Ret_Perctshown_SCG$	$D_Ret + D_Ret_Perctshown$
LIA	$D_Ret + D_Ret_SCG$	D_Ret

Figure 2. Expected effects – Grouping Variables (Actual numbers are presented in Table 5)

The results for this hypothesis are presented in Table 4 and Table 5. In Table 5, for the HIA firms, as we compare and contrast the firms subject to HCG versus WCG, notice the increase in coefficient value from 0.022 to 0.122, $F\text{-Value} 5.93$, $p\text{-value} 0.015$. This shows a 10% increase in conservatism when HIA firms are subject to SCG compared to WCG. Also, among the HCG firms, those subject to HIA as compared to LIA, exhibit higher conservatism (coefficient change from 0.05 to 0.122, an increase of 7.2%, with $F\text{-Value} 11.82$ and $p\text{-value} < 0.0006$. This shows that HCG has a clear dominant effect when firms are subject to High Incentive Alignment and High Corporate Governance. This result is consistent with the hypothesis that in the presence of Strong Corporate Governance, firms with High Incentive Alignment report conservatively, as compared to Low Incentive Aligned firms. It is also important to note that Strong Corporate Governance imposes a certain level of basic conservatism among low incentive aligned firms as well, ($\beta_3 = 0.05$) but it is significantly lower than the level of conservatism imposed on the HIA firms. Further, this result is also consistent with the notion that Highly Incentive Aligned managers, when faced with high monitoring as well, will adopt to the overall principles laid out by their board relatively more efficiently than the Low Incentive Aligned managers. This finding can also be understood as HCG being an *omitted* variable in the Lafond and Roychowdhury (2008) model.

Table 4. Main Hypothesis

High Incentive Alignment versus Low Incentive Alignment *in the presence of* Strong Corporate Governance (SCG)

Dependent Variable: Post-Managed Earnings/Beginning Price

$$\begin{aligned}
E_{it}/P_{it-1} = & \alpha + \beta_1 D_{it} + \beta_2 RET_{it} + \beta_3 (RET_{it} \times D_{it}) + \beta_4 PERCENTSHOWN_{it} \\
& + \beta_5 (D_{it} \times RET_{it}) * PERCENTSHOWN_{it} + \beta_6 SCG_{it} \\
& + \beta_7 D_{it} * PERCENTSHOWN_{it} + \beta_8 (RET_{it} \times D_{it}) * SCG_{it} \\
& + \beta_9 D_{it} * SCG_{it} + \beta_{10} RET_{it} * SCG_{it} * PERCENTSHOWN_{it} \\
& + \beta_{11} RET_{it} * SCG_{it} + \beta_{12} RET_{it} \\
& * PERCENTSHOWN_{it} + \beta_{13} D_{it} * PERCENTSHOWN_{it} * SCG_{it} \\
& + \beta_{14} PERCENTSHOWN_{it} * SCG_{it} \\
& + \beta_{15} (D_{it} * RET_{it}) * SCG_{it} * PERCENTSHOWN_{it} + \text{controls} \\
& + \varepsilon_{it}
\end{aligned} \tag{4}$$

Variable	Coefficient	T-Value	P-Value
Intercept	0.038	6.68	<0.001
D	-0.003	-0.82	0.4110
Ret	0.014	2.19	0.02
Percentshown	-0.006	-1.54	0.12
D_Ret	0.055	3.63	0.001
Ret_Percentshown	0.021	2.02	0.04
Ret_D_Percentshown	-0.033	-1.46	0.14
D_Percentshown	0.001	1.46	0.145
SCG	-0.00	-0.24	0.81
Percentshown_SCG	0.007	1.40	0.16
Ret_Percentshown_SCG	-0.02	-1.91	0.057
Ret_D_SCG	-0.005	-0.29	0.7725
Ret_D_Percentshown_SCG	0.10	3.16	0.001
Size	0.002	3.10	0.002
Leverage	0.001	1.39	0.16
ROE	0.001	21.21	0.00001
Market to Book	-0.005	-17.25	0.0001
Total number of observations	1428		
R square	0.354		

Table 5. Level of conservatism for HIA-SCG versus LIA-WCG groups

DepVar:Earnings	SCG	WCG	F-value, p-value*
HIA	0.122	0.022	5.93, p< 0.015
LIA	0.05	0.05	
F-value, p-value**	11.82, p<0.0006		

* F-value and p-value for comparison between SCG and WCG, within HIA.

** F-value and p-value for comparison between HIA and LIA, within SCG.

Variable Definitions for Tables 4 and 5

E_{it}/P_{it-1} = Annual earnings per share (Annual COMPUSTAT Data 58) / Price at the beginning of the year (Annual COMPUSTAT Data 199).

$D = 1$ if RET is negative, and 0 otherwise.

RET = 12-month return starting from the fourth month after the end of the previous fiscal year.

SCG = 1 if the Totgov* Index is above the median and 0 otherwise.

Totgov index = Totgov Index = Standardized Total Governance Index consisting of four factors which are Gompers Index, percentage of independent board members, inverse of number of board meetings and CEO duality.

HIA = 1 if Percent shown is above the median and 0 otherwise.

5. Sensitivity tests to check for cross-sectional correlation

Based on recent standards in research for robustness checks (Gow, 2010 and Petersen, 2009), standard errors are reported after clustering for firm and time effects. I use the Petersen (2009) method to check if both firm fixed effects and time period effects are likely to be present in the data. In untabulated results, the t-statistics hold and the p-values are significant on all major results. Thus the robustness check adds further credence to the main results.

5.1 Limitations and Future research

It is possible that the quality of auditing affects the level of conservatism enforced as the higher the quality of the audit, the higher the likely levels of observed conservatism in financial reports. In future research, it would be interesting to study the role of the quality of audit on the overall enforcement of conservatism.

Second, this paper looks at the role of HIA as defined by managerial ownership, *excluding* share options and finds that in the presence of high managerial ownership and strong corporate governance, firms report more conservatively. Since inclusion of options would expand the time line of incentive alignment to a longer horizon, I anticipate that the role of strong corporate governance may diminish and therefore the observed accounting conservatism could be lower with the inclusion of share options. I leave the study of this dimension to future research.

Third, future research could look into whether the non-monotonic relationship between asymmetric timeliness and firm ownership is associated with family ownership.

6. Conclusion

In this paper, I test the joint effects of strength of corporate governance and incentive alignment on conservatism and find that in the presence of strong corporate governance, high incentive alignment firms report more conservatively than their less incentive aligned peers. Thus, I establish that strong corporate governance imposes relatively more conservatism among high incentive alignment firms than among low incentive aligned firms. I attribute this to a possible reason that the board of directors would not know *ex-ante* whether high incentive alignment could produce side-effects such as shareholder expropriation and personal entrenchment through earnings overstatement.

Thus this paper shows that although there is lesser need for conservatism when agency costs are low, under the imposition of high monitoring on this group, we can observe conservatism in their financial reports. Thus, high monitoring results in the adoption of conservatism where it is perhaps not necessary. This is the unique finding of this paper which has implications for standard-setting and debates on the cost-benefits of conservatism.

The findings further the understanding of the conditions under which costly monitoring mechanisms and reporting principles are beneficial (when incentive alignment is low) and the conditions under which it would be beneficial to save costs and not have a "one size fits all" approach to monitoring mechanisms and reporting principles (Sivaramkrishnan and Yu, 2008; and Karuna, 2009). Thus, these findings contribute to FASB's current debates on the appropriateness of conservatism versus neutrality. To the best of my knowledge, such a result has not been established in prior literature.

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Notes

Note 1. Note that the terms monitoring and enforcement are used interchangeably.

Note 2. Adams, 2000 shows that the number of board meetings is inversely related to firm value.

Note 3. The Governance Index has been taken from Metrick's website which is www.som.yale.edu/faculty/am859/data.html