

Board of Director' Risk-Taking Characteristic and Accounting Conservatism

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Abstract

This study aimed to examine the effect of characteristics of directors in risk-taking on accounting conservatism. The research is done on companies listed on Indonesia Stock Exchange. Sampling methods used purposive sampling with judgment sampling technique, consisting 55 companies during observation period of 2012. Data obtained through survey and documentation. Partial least squares be used to analyze.

The results showed that the risk-taking characteristics of directors (gender, compensation, stock ownership, and conservative attitudes) affect accounting conservatism. This provides empirical evidence for type theory that character of risk taking behavior of directors determine the company's financial reporting.

Keywords: Gender, Stock Ownership, Compensation, Conservative Attitudes toward Risk, Accounting Conservatism.

1. Introduction

Flexibility of management in determining the method and accounting estimates that can be used would influence the behavior of managers in performing the accounting and reporting of financial transactions. Under conditions of doubt, a manager tends to apply conservative accounting principles. Conservatism concept states that when faced with uncertainty, management will use the accounting treatment option which describe the situation to be less favorable. It recognizes the implications for the possibility of a loss and do not immediately recognize the income or the possibility of profit in the future (Suardjono, 2005: 245).

Accounting conservatism is a concept in the company's accounting practices which chooses a generally acceptable accounting method where revenue recognition would be slower, speed up the recognition of costs, lowering asset valuation, and raise the debt assessment (Wolk and Tearney, 2001). Very conservative accounting practices related to the behavior of managers that have an impact on the presentation of information in the financial statements, which is the information for financial statement users (stakeholders). Accounting conservatism is a useful option in the face of uncertainty (Hendriksen, 1982).

The increased level of conservatism in American firms (Basu, 1997; Givoly and Hayn, 2000) and on public companies in Indonesia (Sayidah, 2005), as well as Lara, Osma, and Penalva (2005) which states that financial institutions wants more conservative accounting numbers presented on the balance sheet.

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Accounting conservatism practice provide benefits in encounter company's internal risks, such as risk reduction of future operating cash flow (Biddle et al., 2011) and managers decision making to acquire the riskier companies (Kravet, 2010), and in facing systematic risk (Qi, 2011). These studies illustrate that risk plays an important role in shaping managers reporting behavior. This study uses directors risk-taking characteristics to identify the behavior of managers reporting.

In the early decision-making with regard to risk, managers have certain characteristics that can distinguish and classify its level of risk tolerance with others. Grable (1997) explains that managers with risk tolerance and managers with a low tolerance may differ in taking risks, consistent with the theory which states that every manager is different from the others in accordance with its character (Robbins, 2001: 80). Risk taking characteristics of board of director that is used to describe the level of implementation of accounting conservatism are gender, compensation, stock ownership, and conservative attitudes.

In decision making, manager's behavior is largely determined by personality formation process, social experiance, capabilities, and presence as women and men. Men tend to produce a risky choice (Amanatullah, Shropshire, James, and Lee; 2010) and women tend to show a safer option that is more likely to adopt policies more conservative financial reporting (Francis, Hasan, Park, and Wu; 2011). MacCrimmon and Wehrung (1986) stated that individual with higher income more inclined to take greater risks compared individual with low incomes. Risk taking agent behavior will affect risk-taking behavior of managers reporting to be less cautious. As one way to improve performance and to motivate managers, business owners mas provide part of the company's shares to the manager. Grable (1997) states that the level of risk tolerance is determined by the position of employees in the company. The higher employee positions, the higher level of risk tolerance. The attitude of managers in taking risk describes their readiness to face any consequences that may arise from their actions. The attitude in the face of risk is a development factor used by MacCrimmon and Wehrung (1986) and

Grable (1997) to measure the level of risk tolerance. In the face of risk, every manager has different behavior determined by personality traits or character. The level of risk tolerance describe how much risk is tolerated, in contrast risk-averse managers who avoids risk are being conservative.

Objective of this study is to provide empirical evidence on the issue of the characteristics board of directors (gender, compensation, stock ownership, conservative attitudes) in decision-making toward risk will encourage managers to adopt accounting conservatism.

Theoretical contributions to the type theory have never been used in the development of research in the field of accounting, particularly in Indonesia. The empirical evidence is clear that compensation and conservative attitude towards risk is a factor that affects accounting conservatism, is a contribution to the practice of this research for *stakeholders*.

2. Literature Review and Hypothesis Development

2.1 Type Theory

Myers-Briggs identified 16 traits (reserved, less intelligent, influenced by feelings, caving, serious, easily prepared, shy, hard-hearted, trusting, practical, forthright, confident, conservative, depending on the group, out of control, and relaxed) as a source of behavior is generally fixed (*steady*) and a constant, which allows forecasting the behavior of someone in particular situations by considering the characteristics of the situational relevance. Type theory states that every individual is different in his/her willingness to take chances (Robbins, 2001: 18-54). People with certain characteristics tend to be relatively consistent in attitudes and behavior over time and in different situations. Type theory focuses more on strength characteristics in predicting attitudes and behavior of people.

2.2 Accounting Conservatism

Sterling (1970) states that conservatism is the principle on which reporting standards that are applied to offset optimism that management tends to overstate excessively on the financial statements. Wolk *et al.* (2001) defines accounting conservatism as an attempt to choose a generally acceptable accounting method to slow down the recognition of revenue, accelerate the recognition of costs, lowering asset valuation, and raise the debt assessment.

2.3 Board of Directors Gender and Accounting Conservatism

Mikkola (2005) defines gender as a description of the nature, attitudes, and behaviors of men and women. Type theory suggests that men and women have different characteristics. Men have more daring characteristics and tend to process information in a limited way in decision making and tend to be less conservative. Women tend to prefer a safer choice in decision making. Amanatullah *et al.* (2010) stated that in making decisions, men tend to produce a risky choice. Conversely, women tend to show a safer option, so making them more likely to adopt a more conservative financial reporting (Francis *et al.*; 2011). Based on the above description, research hypotheses are formulated as follows.

H₁ : Proportion of women directors have positive effect on accounting conservatism.

2.4 Board of Directors Compensation and Accounting Conservatism

MacCrimmon and Wehrung (1986) stated that individual with more income are inclined to take greater risks compared to individual with low incomes. Blume (1976) stated that the increase in income is a generally accepted characteristics for individuals with high risk tolerance. This illustrates that high compensation characterize individuals who have a high risk tolerance level, in contrast to individuals with low tolerance levels, as described in the type theory. Eisenhardt (1989) describes the difference in attitude in the face of risk between principal and agent based compensation contracts, that *risk-averse* agents will be reduced if agents obtain higher compensation. The attitude of risk-taking agents would affect the behavior of managers reporting to be less cautious because it is driven by the presence of particular interest. The greater compensation received by the manager, the less conservative the resulting report. Based on the above description of research hypotheses are formulated as follows.

H₂: Board of directors compensation have negative effect on accounting conservatism.

2.5 Board of Directors Stock Ownership and Accounting Conservatism

Ownership of company stock by employees potentially increase the motivation to work by allowing employees to participate in running the company (Robbins, 2001: 210). The existence of company's shares owned by the manager, will change the behavior of managers becomes more bold in deciding company management policy, including decisions related to risk and tend to be not so inclined to apply accounting conservatism. Xia *et al.* (2009), Lafond and Roychowdhury (2007), as well as Widanaputra (2007) states that the higher ownership interest by the company management, the less conservative accounting reports becomes. Based on the above description, the research hypothesis is formulated as follows.

H₃: Board of directors stock ownership have negative effect on accounting conservatism.

2.6 Board of Directors Conservative Attitudes towards Risk and Accounting conservatism

Kravet (2010) explains that accounting conservatism lowers *managerial risk-taking*. When accounting

conservatism Increased, risky corporate acquisition decisions decreases. Biddle et al. (2011) declared that accounting conservatism affects the risk of lowering operating cash flow. Attitude towards risk plays an important role in shaping the behavior of managers reporting (Qi, 2011). Empirical studies above illustrate the behavior of the manager in the face of risks that affect the behavior of managers reporting.

Individuals with conservative traits tend to act and behave cautiously in every action. This trait is relatively consistent with the attitudes and behavior of individuals (Myers and McCaulley, 1985) so that individuals with these characteristics have a tendency in applying accounting conservatism. Based on the above description, the research hypothesis is formulated as follows.

H₄: Board of Directors conservative attitude towards risk have positive effect on accounting conservatism.

3. Research Methodology

3.1 Population and Sample

The population contains all firms listed on Indonesia Stock Exchange in the period of 2012. Determination of samples using purposive sampling technique with criteria: (1) have female directors, (2) give information about compensation and stock ownership directors, (3) are willing respondents, therefore acquired 55 companies and a response rate of 65.47%.

3.2 Data Sources

Primary data collection techniques using a method of survey by distributing questionnaires adopted from Mas'ud (2004) and measured using a Likert scale four points to describe attitudes toward risk. The collection of secondary data (gender, stock ownership, and compensation, and accounting conservatism) using the documentation method obtained from *the website* of the Indonesia Stock Exchange (www.idx.co.id).

3.3 Variable and Measurements

- 1) The dependent variable, is the accounting conservatism to indicate how conservative the company in choosing accounting method. Measurement of accounting conservatism using the formula Givoly and Hayn, 2000 as follows.

$$AC = \frac{\text{net income before extraordinary items} + \text{depreciation expense} - \text{cash flows from operations}}{\text{average total assets}}$$

- 2) Independent variables
 - a) Gender using the proportion of female board member (Amanatullah et al., 2010).
 - b) Stock ownership using the proportion of board shares owned (Lafond and Roychowdhury, 2007; Widanaputra, 2007; Xia et al. 2009).
 - c) Compensation use the proportion of board income received (Grable, 1997).
 - d) Board Conservative attitude describe how the board behavior towards risk through statements which indicate the attributes of risk taking.

3.4 Empirical Model

The analysis used Structural Equation Modeling (SEM) based on a variant or Partial Least Square (PLS) assisted by Smarts PLS 2.0 software applications program based on the consideration that this research using structural equation that has a weak theoretical basis, as well as the use of unobservable and observable variables. PLS model evaluation is done by evaluating outer model and inner model. Inner equation models as presented below.

$$Y_1 = Y_1 X_1 + Y_2 X_2 + Y_3 X_3 + Y_4 X_4 + \zeta_1$$

Description:

- X₁₋₄ = variables of gender (G), stock ownership (SO), compensation (C), conservative attitude to risk (CA)
 Y₁ = variable of accounting conservatism (AC)
 Y₁₋₄ = coefficient of variables gender, stock ownership, compensation, conservative attitudes toward risk
 ζ₁ = Error rate (errors)

Outer Model used to test the construct validity and reliability of the instrument were based on Rule of thumb, outer models equation are presented below.

$$X_{4.1-20} = \lambda_{x_{4.1-20}} \zeta_{4.1-20} + \delta_{4.1-20}$$

Description:

- X_{ni} = indicators of exogenous latent variables of conservative attitude towards risk
 ζ_n = latent exogenous variables of conservative attitude towards risk
 λ_n = loading factor of each indicator variable
 δ₁ = degree of measurement error on exogenous variable

4. Results and Discussion

4.1 Sample Description

The data of descriptive statistics for each research variable are presented in Table 1. The median value of each variable is as follows: gender (G) 29.7%, compensation (C) 13.39% stock ownership (SO) 3.49%, and the level of accounting conservatism -0.0521. Conservative attitude towards risk from the respondents' answers indicate the average value of 2.53 which indicates that the conservative attitude is highly perceived by respondents.

4.2 Testing Non-Response Bias

Non-Response bias testing was performed to see if the late response give biased results compared to a timely response. Non-Response bias test results presented in Table 2 which shows that the p-value of each indicator > 0.05 so it was concluded that the instrument used meets non-response bias test.

4.3 Testing Measurement Model (Outer Model)

The test results of convergent validity demonstrated that there are 5 invalid items out of 20 items, which is looking for life experience (S11), the need for achievement (S12), a lot of energy (S13), generating ideas to make money (S14), and independence of thought (S19). The estimation result again showed the AVE value of $0.5262 > 0.05$ and communality of $0.526199 > 0.05$ which means that all items are valid in constructing conservative attitude towards risk (CA), so it can be concluded that the measurement meets the criteria of convergent validity.

Test results of discriminant validity demonstrated the AVE value of 0.526 and the root of the AVE of 0.725 which is higher than the correlation coefficient between variables of accounting conservatism (AC) of 0.323, so it can be concluded that the indicators used meets the criteria of discriminant validity.

The test results demonstrate the value of *alpha* amounted to 0.936896 and composite reliability of 0.943307 is > 0.7 , which means that the measurement used in this study is reliable.

4.4 Testing the Structural Model (Inner Model)

4.4.1 Testing Linearity Assumption

In the PLS analysis, there is an assumption that must be met, namely the assumption of linearity. The test results of linearity assumptions are presented in Table 3 which shows linear model significance of < 0.05 for the fourth inter-variables so that influence the linearity assumption is met.

4.4.2 Structural Model Goodness of Fit

The Goodness of fit test results demonstrate independent variables (gender, stock ownership, compensation, and a conservative attitude towards risk) affect the dependent variable of accounting conservatism by 92.47%, while the rest is influenced by other variables that are not involved in this study.

4.4.3 Hypothesis Testing

In the inner model, four hypotheses were tested and influence among variables deemed significant if the value of the T-stat > 1.64 . Results of hypothesis testing presented in Table 4. The test results of hypothesis 1, 2, 3, and 4 show the value of the T-stat > 1.64 which means the all 4 hypotheses are accepted.

4.4.3.1 Board of Directors Gender and Accounting Conservatism

The test results showed a positive effect of board gender proportion to accounting conservatism. The higher number of women directors in the board of directors, the higher the level of accounting conservatism. The existence of gender differences in the behavior of men and women will influence the decisions taken. Men who tend to be less conservative would not consider adopting conservative accounting. Conversely, women who tend to be conservative will tend to consider the application of conservative accounting in the hope of gaining security and certainty. This supports the type theory that states that the gender characteristics of men and women are different toward decisions related to risk. Behavioral differences of men and women in the face of risk will affect the adoption of accounting conservatism. The results of this study are consistent with the findings of Francis *et al.* (2011) which states that the female gender effect on accounting conservatism.

4.4.3.2 Board of Directors Compensation and Accounting Conservatism

The test results showed negative influence of board of director's compensation toward accounting conservatism. The higher amount of compensation for board of directors the lower the level of accounting conservatism. Blume (1976) explained that the increase in income is the generally accepted characteristic of individuals with high risk tolerance. This illustrates that income is an individual characteristic of risk taking. Relationship between principal and agent based on the contractual compensation stated that the *risk-averse* agent will be reduced if agents obtain higher compensation. Agent would be willing to take risk if being granted higher compensation. Managers decision to apply accounting conservatism is influenced by the size of the compensation to be received by the manager.

4.4.3.3 Board of Directors Stock Ownership and Accounting Conservatism

Test results indicate a negative influence of director's stock ownership on accounting conservatism. The higher ownership level of directors the lower level of the application of accounting conservatism. Ownership of company's stock by employees potentially increase work motivation by allowing employees to participate in the management of the company (Robbins, 2001: 210). Individual being in a position as a business owner is bolder in making decisions and tends to be not so careful, and more incline to apply accounting conservatism. This research provides support for the empirical study conducted by Xia *et al.* (2009), Lafond and Roychowdhury

(2007), as well as Widanaputra (2007) who explain that the manager who serves as the owner has the characteristics of a risk taker, so he/she tends to not apply accounting conservatism.

4.4.3.4 Board of Directors Conservative Attitudes towards Risk and Accounting Conservatism

Test results show the positive influence of conservative attitudes towards board of director risk on accounting conservatism. Individuals who have a conservative character would behave and act carefully in any action; it is in accordance with the type theory. Conservative individual traits towards risk have a tendency to apply the accounting conservatism. These studies provide support for the empirical study conducted by Kravet (2010) and Biddle et al. (2011) which describes the behavior of the manager in the face of risk affect manager's reporting behavior. Conservative managers in the face of risk tend to apply more conservative accounting compared to managers who are not conservative.

5. Conclusion and Recommendations

Board of director's characteristic in decisions making in relation to risk determine the level accounting conservatism application. The more conservative board of directors wants safer condition and certainty in presenting information to users of financial statements, so they tend to apply accounting conservatism. Board of directors characteristics describe type and effect behavior to be taken such as decision to apply accounting conservatism. The dissimilar decision of the board of directors in applying accounting conservatism determines the level of accounting conservatism. The result of this study support type theory which explains that the differences in each individual character influence individual's behavior. Application of accounting conservatism is influenced by the characteristics of the board of directors.

This research shows that female directors has more cautious characteristics and tend to make safer choices and certainty, while men tend to be less conservative. The existence of men and women in board of directors will influence the decision to applied conservative accounting. Board of directors decision to implement accounting conservatism is influenced by the amount of the compensation to be received. Board of directors who take risks tend to want a high increase in revenue so that they tend to not apply accounting conservatism. The stock ownership by managers will have an impact on the behavior of managers in adopting accounting conservatism. A manager who has increased his capacity as a shareholder would want his company to obtain maximum profit, so he/she tends to not apply accounting conservatism. This illustrates that the manager will be motivated to do something that can improve its utility. Thus, providing support to the type theory. The board of directors with cautious characteristics tends to be conservative and behave prudently in each action including the decision-making related to reporting that tend to apply accounting conservatism.

The limitations of this study are the availability of information over other characteristic in the face of risk and lack of observations that can be used.

Several advices for development and further research can be done by exploring the determinants of accounting conservatism caused by other internal factors that have not been researched and consider increasing the number of samples.

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Table 1. Descriptive Statistics

Variables	Number of Samples	Min Value	Max Value	Average Value	Standard Deviation
Gender	55	0.0769230	0.6666670	0.2969941	0.1642880
Compensation	55	0.0000290	0.4963900	0.1339181	0.1143060
Stock Ownership	55	0.0000002	0.4033154	0.0348969	0.0848532
Conservative Attitude Accounting	55	1.0000000	4.0000000	2.5334000	0.9296000
Conservatism		-0.615171	0.0854160	-0.0520824	0.1325987

Table 2. Test Results of Non-Response Bias

Item	p - value	Information	Item	p - value	Information
S1	0.836	Fulfilled	S11	0.501	Fulfilled
S2	0.647	Fulfilled	S12	0.438	Fulfilled
S3	0.907	Fulfilled	S13	0.852	Fulfilled
S4	0.683	Fulfilled	S14	0.435	Fulfilled
S5	0.267	Fulfilled	S15	1.000	Fulfilled
S6	0.533	Fulfilled	S16	0.836	Fulfilled
S7	0.477	Fulfilled	S17	0.870	Fulfilled
S8	0.281	Fulfilled	S18	0.603	Fulfilled
S9	0.597	Fulfilled	S19	0.702	Fulfilled
S10	0.770	Fulfilled	S20	0.195	Fulfilled

Table 3. Testing Linearity Assumption

Influence between variables		Testing Linear Models	Conclusion
Gender	Accounting Conservatism	The whole model of Non Significant (Sig for Linear Models 0.853 > 0.05, and for the Sig Other Models > 0.05),	Linear
Compensation	Accounting Conservatism	Significant Linear Models (Sig For Linear models 0.026 > 0.05)	Linear
Stock Ownership	Accounting Conservatism	Significant Linear Models (Sig For Linear models 0.004 > 0.05)	Linear
Conservative Attitude	Accounting Conservatism	Significant Linear Models (Sig For Linear models 0.006 > 0.05)	Linear

Table 4. Path Coefficient (Mean, STDEV, T-Values)

Influence between variables	Original Sample (O)	T Statistics (O / Sterr)	Information
Gender -> Accounting Conservatism	0.522649	7.015371	significant
Compensation -> Accounting Conservatism	-0.584940	6.778417	significant
Stock Ownership -> Accounting Conservatism	-0.667446	6.229334	significant
Conservative Attitude -> Accounting Conservatism	0.576734	8.688791	significant

Source: Data processed (2013)