Chapter 14
Accounting Conservatism and Corporate Governance: Firm-Level Evidence From Turkey

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ABSTRACT

In this chapter, the impacts of corporate governance mechanisms on accounting conservatism are examined by using a sample that includes 85 non-financial firms quoted in Borsa Istanbul during the years of 2013 to 2018. The results of empirical analysis indicate that board size, board independency, institutional ownership, and firm size are positively related with accounting conservatism. However, leverage is negatively related with accounting conservatism, while there is no statistically significant association between CEO duality and accounting conservatism. This chapter contributes to limited literature on the association between accounting conservatism practices and corporate governance in the emerging market.

INTRODUCTION

Accounting conservatism, a prominent feature of financial information, is one of the critical issues in the economic environment. Conservatism, one of the most important accounting principles, influences financial reporting process in many ways (Basu, 1997). Accounting conservatism improves the reliability of financial statements by constraining firm managements' opportunistic behavior (Ball and Shivakumar, 2006; Watts, 2003; Mora and Walker, 2015). Additionally, accounting conservatism significantly decreases agency problems within the firm and protects creditors from bad management.

The optimal level of accounting conservatism enhances the quality of financial market participants' decisions. Watts (2003) stated that regulations massively influence accounting conservatism. To save the interests of creditors and investors, standard setting bodies may push firms to adopt more conservative accounting practices (Bushman and Piotroski, 2006).

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The presence of accounting conservatism leads to a decrease in the net profit and total assets. Accounting conservatism enables firms to defer the recognition of positive economic transactions until the realization and recognize negative economic transactions when anticipated.

In today's business environment, management incentives play a pivotal role in financial reporting policies. Lewitt (1998) stated that certain management incentives may lead distortions in firms' financial statements and corporate scandals. The concerns related to management incentives have led the call for the well-established corporate governance mechanisms. Corporate governance mechanisms can be used to effectively mitigate managerial opportunism.

Corporate governance has important effects on the quality of financial statements. Firms having effective corporate governance mechanisms adopt more accounting conservatism (García et al., 2007; Beekes et al., 2004; Ahmed and Henry, 2012). Additionally, cultural values, social norms and macroeconomic structure are important factors shaping corporate governance standards in the business environment.

In the developed economies, the impacts of corporate governance on accounting conservatism have been well documented. However, there are few research studies that aim to analyze the impacts of corporate governance on accounting conservatism in the developing economy. Thus, the finding of the present chapter is prominent as it reveals the impacts of corporate governance on accounting conservatism in the developing economy using a multivariate model.

The rest of the book chapter is structured as follows. Second section discusses literature review and hypotheses development. Third section reveals research design. The results of empirical analysis are discussed in the fourth section. The final section concludes the chapter and provides suggestions for further studies.

LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

In this section of the chapter, literature review and hypotheses development are presented. The investigation of impacts of corporate governance on accounting conservatism practices needs further investigation. The empirical results of previous studies are inconclusive. The majority of studies that investigate the impacts of corporate governance on accounting conservatism are guided by agency theory.

Agency problems emerge between firm management and shareholders. In the modern business environment, the controlling shareholders tend to pursue their own self-interests. This leads to serious agency problems. As the interests of controlling shareholders and minority shareholders differ, the agency conflicts are likely to occur within the firm.

Corporate governance mechanisms have a critical role in solving these problems (Mohammad et al., 2017). Corporate governance mechanisms can constrain firms' management opportunism. The ownership structure in Turkey and other emerging economies is highly concentrated. Agency problems frequently emerge within firms operating in developing economies. Information asymmetry among controlling shareholders and minority shareholders prompts accounting conservatism practices (LaFond and Watts, 2008).

According to the agency theory, the appointment of independent board members can decrease agency problems through monitoring the firm management's actions (Fama, 1980; Jensen and Meckling, 1976). In the competitive economic environment, the independent board members are strongly needed on the board of firms to effectively monitor the actions of management.