

CEO Powerful Features on Conditional and Unconditional Conservatism

Saeedeh Rezaee ^a, Yousef Taqipouriani ^{b*}

^a Master of Accountancy (MAcc), Islamic Azad University of Chalous, Chalous, Iran.

^b Department of Accounting and Management, Faculty of Management and Accounting, Islamic Azad University of Chalous, Chalous, Iran.

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Abstract: The present study aimed to investigate the characteristics of CEO capabilities on the conditional and unconditional conservatism in companies listed on Tehran Stock Exchange. In order to test research hypotheses after collecting and screening the initial data a sample consisting of companies listed on Tehran Stock Exchange, up to 142 companies in a period of 6 years (2012-2017) was studied. Excel was used to calculate and classify the research variables. Then, using the multiple regression analysis in Eviews, we test the research hypotheses. The results of the research showed that the CEO abilities do not have a positive and significant effect on conditional conservatism but have a positive and significant on unconditional conservatism.

Keywords: *CEO Ability, Conditional Conservatism, Unconditional Conservatism*

1. Introduction

Agency theory usually says that in order to make a balance between the motivations of prominent managers and stakeholders' interests, it is necessary to use the options of CEO stock and incentives of equity (Jensen and McLean, 1976; Fama and Jensen, 1983). However, in countries with poor corporate governance, the payment method will be based on relationship-based contract instead of market-based contract (Lou and Jackson, 2012) and management is towards taking actions to increase personal well-being through consuming more resources and at the expense of minority shareholders (Schlifer and Vishni, 1997). In addition, "when the CEO becomes more powerful, it is more likely to made decisions with more severe consequences" (Adams, Almedia and Feria, 2005). However, the optimal reward contract is important because the power of CEO not only affects the minority shareholders but also the stability of national economy. For example, in the 2008 economic crisis, the weak motives of banks CEOs have been criticized for being one of the main reasons of the financial crisis (Blinder, 2009; Fallen Burch and Stalls, 2011). As a result, regulators should continually improve their understanding of corporate governance in the banking system and increase their ability to monitor the risks that banks take it (Hangen Druff, Kleins & Casey, 2007).

On the other hand, conservatism is one of the characteristics of financial reporting, which in form of a limiter in the framework of accounting principles and concepts plays an important role in limiting the optimistic behavior of managers in the position of information producers and estimating the least earnings by investors and creditors in the position of the most important users. Conservatism (asymmetric verifiability) can also be created for reasons of employment contract and corporate governance. Managers want to hide the losses in order to avoid being fired before the end of their tenure. Making companies to get detriment and adopting projects with a net negative present value by managers encourages shareholders to fire managers. Conservatism speeds up the identification of losses and provides signs board members and shareholders to explore the causes of these losses. Such studies can lead to keep the manager and eliminate projects with a negative net present value. Therefore, managers are motivated to provide information about projects with a positive net present value. Contractual arguments of conservatism accounting are used for most accounting applications of the company, including criteria of management performance for company departments such as profit centers. In such cases, responsible employees, have asymmetric information, asymmetric returns and limited ability. These arguments are used for profit centers and budgets to control the expenses. Although conditional conservatism is achieved through recognizing of good news events as achievements under a higher endorsement standard, it is used as a detriment in identifying bad news events, it is not necessarily reflected in accrual items. Less conservatism accounting due to the horizon problem will lead to an increase in accrual items such as higher accounts receivable or inventory, but total accruals are not necessarily higher due to the repercussions of other accruals, such as accounts payable (Chen et al., 2020). Therefore, given the importance of the issue, in this article the effect of CEO capabilities on conditional and unconditional conservatism will be studied.

2. Discussion

In examining the influence of powerful CEOs on the firm's innovation program, it is also necessary to investigate the origin of the CEO (i.e. the external or internal CEO). This distinction is effective and pivotal. Due to the impact of the CEO's origin on the ability of the firm to adjustment, this leads to the realization of different organizational outputs. In particular, this paper seeks to understand these issues that how firms managed by outside CEOs (hired from the outside of the firm) differ from firms managed by inside CEOs (appointed from the inside) in terms of different decisions. This distinction due to the differences in experience, knowledge, skills, and access to resources

for each CEO is of great interest to researchers. Studies by confirming these differences suggest that outside CEOs usually bring new ideas and new perspectives to the company, but inside CEOs generally have a specific knowledge about the company that is the result of their experience within the firm. Hence, the origin of the CEO can affect the company's innovation activities. Conservatism is one of the prominent features of financial reporting that has attracted more attention in recent years due to financial scandals (in companies such as Enron and World Com, and some recent studies such as Watts, 2003; Lafonde and Watts, 2006, have focused specifically on conservatism). Although many accountants agree on the existence of conservatism in the regulation of financial statements, a comprehensive and unambiguous definition has not been provided. However, in accounting papers two main characteristics of are examined: First, the downward of the capital book value relative to its market value, and second, tend to accelerate the identification of costs and postponing of revenue recognition (Price, 2005). Watts (2003) by quoting from Bliss (1924) in his definition of conservatism said that "Conservatism is traditionally defined by the proverb that no profit is anticipated, but all losses are anticipated." In accounting literature, the proverb has been interpreted as "the tendency of accounting to require a higher degree of verifiability to identify good news, that is, profit is interpreted with identifying bad news (loss) (Basso, 1997; Watts, 2003).

Basso (1997) defined conservatism as follows: Conservatism is a different verifiability needed to identify income and expenditure, which leads to understatements of profits and assets. This definition reflects conditional conservatism. Recent studies have divided conservatism into two types: First, ex ante conservatism that is also called news-independent conservatism and unconditional conservatism. Ex ante conservatism stems from the application of accounting standards that reduce profits independently of current economic news. For instance, immediate identification of advertising and research and development expenditures as a cost, even if the expected future cash flows are positive, is of this type. Another type of conservatism is ex post conservatism, which is also called news-dependent conservatism, conditional conservatism, and asymmetric income timeliness. Ex post Conservatism means timely identification of bad news than good news in profit. For example, the principle of lower of cost or market value, the elimination of goodwill following a devaluation test, and the asymmetric identification of potential losses against potential profits are of this kind. In general, accounting principles require identifying a reduction or bad news about inventory, goodwill, and potential losses; but they forbid the identification of an increase in good news (Pai et al., 2005). Conditional conservatism was first introduced by Basso (1997) as an important aspect of conservatism (Ryan, 2006).

The major motivation for unconditional conservatism is the difficulty of assessing assets and liabilities. The main motivation for conditional conservatism is to offset managers' motivations for reporting up-to-date accounting information when inappropriate events occur. There are similar motives for these two types of conservatism. For instance, asymmetric loss function of investors make the effect of the benefits they gain from profits less than the harms they see from losses with the similar importance. These two have similar concepts that increasing the net market value of their assets to their book value is really important to them (Beaver and Ryan, 2004).

On the other hand, the direct role of CEOs in shaping the organization's multiple outputs has been proven by different important methods. Changes in the company's outputs are the direct result of strategic choices made by CEOs according to their work experience, training experience, and different networks. Among senior executives, the CEO has a unique impact on the corporate processes and outputs, which in turn determines probable success of the firm. Because of their influence, CEOs have a lot of authority over their strategic choices and subsequent decisions. Here, influence is defined as the "capacity of each performer to impose his or her will" as a means to achieve the goals.

In addition, CEOs that are members of the board and adopt conservative accounting methods can ensure accountability by explaining the management of implementing such accounting procedures in the company, especially the impact of conservative accounting on stock price movements, on the credibility of company management, risk, etc. Internal controls versus, previous research also suggest that being a member of the board of directors provides more authority to executives, this can affect negatively on the quality of accrual items and consequently aggressive accounting methods (Bezley, 1996; Dechow et al., 1996). Thus, the CEOs abilities can affect conditional and unconditional conservatism (Matkin et al., 2019).

3. Literature Review

Zhang (2020) studied conditional conservatism and trade credit during the global financial crisis. The results showed that there is a positive relationship between conditional conservatism and companies' access to trade credit before and after the crisis, which indicates the demand of suppliers for conditional conservatism. Meanwhile, the relationship between conditional conservatism and trade credit experienced a significant degradation after the beginning of crisis, and this only happens if suppliers and customers have repeated transactions or are near to each other, when the traded goods are standard and not differentiated, when the customers were there and they were financially constrained and had high bargaining power, and when suppliers had enough cash.

Matkin et al. (2019) investigated the effect of the CEO's tenure and the CEO's membership in the board on conservatism. The results suggested that while long-term tenure of CEO and his board membership increase the conservatism of accounting, this is not achieved when CEOs enter the board through long-term tenure. It seems that this employment leads to the use of aggressive accounting methods. In general, the results indicate that the CEO tenure and being a member of the board of directors improves the quality of financial reporting by promoting accounting conservatism in organizations.

Chen et al. (2017) explored the retirement of the CEO, corporate governance, and conditional conservatism. They found that CEOs report more conservative accounting reporting before their retirement than CEOs who are not retired yet. Then, they found that corporate governance reduced the effect of the CEO's retirement on conditional conservatism. In addition, it shows that only retired CEOs with poor corporate governance are likely to report less conservative income before their retirement.

In Iran, Pourseif, Sajjad et al. (2009) examined the effect of conditional conservatism on auditor withdrawal with emphasis on corporate governance in companies listed on the Tehran Stock Exchange, during 2013-2017. In their research, conditional conservatism is considered as an independent variable and auditor withdrawal as a dependent variable and corporate governance as a moderator variable and variables of market value to book value ratio, company size and financial leverage as control variables. In general, results of the hypotheses indicate the opposite and significant effect of conditional conservatism on the auditor's resignation; furthermore, the effect of corporate governance variables on the relationship between conservatism and auditor resignation showed that board independence increases the severity of the reversal effect of accounting conservatism on auditor resignation, and board size and the duality of CEO duty reduces the severity of the conservative reversal effect on auditor resignation in the companies listed on the Tehran Stock Exchange.

Khodadadi, Vali et al., (2016) examined the effect of board independence on the relationship between accounting conservatism and research and development costs in the Tehran Stock Exchange. The results indicated that the independence of the board of directors and the costs of research and development (innovation) had a significant effect on conservative accounting, and also the independence of the board of directors had a moderating effect on the relationship between research and development costs (innovation) and conservative accounting and increased the relationship between them.

The novelty of this research can be explored from three perspectives: First, in explaining the impact of the CEO's capabilities on conditional and unconditional conservatism, no research has been done in Iran so far, which is new in its kind. Second, the used model examines the capabilities of the CEO on conditional and unconditional conservatism in this study has been used for the first time in Iran, which also adds to the novelty of this research. Third, there has been no research that simultaneously examines the capabilities of the CEO, and the conditional and unconditional conservatism together.

4. Research Hypotheses

1. The CEO's ability has a positive and significant effect on conditional conservatism.
2. The CEO's ability has a positive and significant effect on unconditional conservatism.

5. Research Method and Statistical Population

The hypotheses of this research have been modeled in the form of specific regression relationships, and therefore it is necessary to examine the fundamental assumptions of these very important relationships before testing these regression relationships and analyzing their results.

The Statistical population is Companies accepted in Tehran Stock Exchange. In order to conduct research, the statistical sample of the companies listed on the stock exchange during 2012-2017, has been selected according to the following criteria:

- The required information about companies during 2012 to 2017 should be available.
- The end of the financial year of the companies should not be changed at the end of March and during the years of 2012 to 2017.
- Shares of companies should be traded on the stock exchange during each of the years of the research period and the price of the end of period should be available.
- Should not be part of investment companies and financial intermediation.
- Taking these criteria into account, 142 companies were selected as a sample using random sampling method.

5.1. Research Model

$$\text{Rank UCI}_{i;t} = \alpha_0 + \alpha_1 \text{P.F.CEO}_{i;t} + \alpha_2 \text{Control Variables}_{i;t} + \epsilon_{i;t}$$

$$\text{Rank CCI}_i;t = \alpha_0 + \alpha_1 \text{ P.F.CEO } i;t + \alpha_2 \text{ Control Variables}_i;t + \epsilon_i;t$$

Dependent Variable:

Rank UC_i: Unconditional conservatism which is measured by the following model:

$$\text{Rank UC}_i;t = \alpha_0 + \alpha_1 \text{ AQP}_i;t + \alpha_2 \text{ A}_i;t + \alpha_3 \text{ TLSFU}_i;t + \alpha_4 \text{ MVBV}_i;t + \epsilon_i;t$$

Rank CC_i: Conditional conservatism which is measured by the following model:

$$\text{Rank CC}_i;t = \alpha_0 + \alpha_1 \text{ Rank UC}_i;t + \alpha_2 \text{ AQP}_i;t + \alpha_3 \text{ A}_i;t + \alpha_4 \text{ TLSFU}_i;t + \alpha_5 \text{ MVBV}_i;t + \epsilon_i;t$$

Where we have:

- AQP: The stock of companies with high quality disclosing i company in the year t
- A: The average logarithm of total assets of company i in the year t
- TLSFU: Total liabilities divided by the market value of equity for Company i in the year t
- MVBV: The ratio of the market value to the book value of company i in the year t

5.2. Independent Variable

- Powerful features of CEO (P.F.CEO): A dummy variable (imaginary variable) is equal to one if the number of seven variables of the CEO ability is greater than the mean; otherwise it is equal to zero. The seven variables of CEO powerful features are as follows:
- Cps: CEO Reward to the other board members reward
- Duality: Executive director: dummy variable is equal to one if the CEO is an executive director, otherwise it is equal to zero.
- Outside Directors: The percentage of dormant member of directors is greater than all board members.
- CFO ownership: The ownership of the CEO is equal to the percentage of ownership of the CEO.
- Founding Family: A dummy variable is equal to one if the CEO is a member of the founding families of the company and otherwise is equal to zero.
- Tenure: CEO's tenure has been calculated through the CEO's number of years.

5.3. Control Variables

- Sale: The ratio of book value to company market value.
- Lev: Financial leverage which is measured through the division of total debt into total assets.
- Ret: Returns the company's stock.
- CFO: It is the company's operating cash flow.

6. Research Findings

Descriptive statistics of the research variables are presented in the following table:

	RANK_CC	P_F_CFO	SALE	RET	LEV	CFO	RANK_UC
Mean	0.018609	0.697183	14.04132	0.317491	0.544134	1012399.	-0.375462
Median	0.009754	1.000000	13.94197	0.000000	0.567281	149625.0	-0.362354
Maximum	0.150080	1.000000	19.80892	8.594987	4.002704	33466694	0.726451
Minimum	0.000000	0.000000	0.333905	-0.689911	-4.971602	-6446290.	-0.896263
Std. Dev.	0.023521	0.459747	1.782173	0.836671	0.456218	2983690.	0.191874
Observations	852	852	852	852	852	852	852

Hypothesis 1: CEO powerful features have a positive and significant effect on conditional conservatism.

Variables	Coefficient	Standard deviation	t-statistic	Probability
CEO capability	-2.88E-05	0.000139	-0.206865	0.8362
Sales	-0.000226	0.000176	-1.286142	0.1988
Stock return	-0.000117	9.25E-05	-1.264540	0.2065
Financial leverage	-0.000312	0.000251	-1.242061	0.2146
Operational cash flow	1.45E-10	1.41E-10	1.030266	0.3032

Stationary component	0.021868	0.002507	8.722995	0.0000
Coefficient of determination	0.712			
Adjusted coefficient off determination	0.652677			
Durbin-Watson statistic	1.598286			
F-statistic	11.95320			
Probability of F statistic	0.000000			

According to the above table, the results of hypothesis showed that the CEO's ability does not have a positive and significant effect on conditional conservatism.

Hypothesis 2: The CEO's ability has a positive and significant effect on unconditional conservatism.

Variables	Coefficient	Standard deviation	t-statistic	Probability
CEO capability	0.016494	0.008392	1.965486	0.0498
Sales	0.008518	0.003584	2.376353	0.0178
Stock return	-0.004067	0.003655	-1.112576	0.2663
Financial leverage	0.018572	0.003699	5.020373	0.0000
Operational cash flow	4.50E-10	1.22E-09	0.370078	0.7114
Stationary component	-0.515836	0.050551	-10.20426	0.0000
Coefficient of determination	0.712603			
Adjusted coefficient off determination	0.653085			
Durbin-Watson statistic	1.498236			
F-statistic	11.97294			
Probability of F statistic	0.000000			

Based on the above table, the results of the hypothesis showed that the CEO ability has a positive and significant effect on unconditional conservatism.

7. Conclusion

Conservative accounting methods can reduce the manipulation of potential revenue by managers, which can increase potential profitability by selecting aggressive accounting methods that do not require a higher degree of validation to detect good news in financial statements. Given the fact that the investors' decisions have been reported to rely on financial information, according to Basso's research, accounting conservatism needs to be informed timely about bad news precisely because investors, debtors and creditors as remaining claimants are sensitive to the enhancement of enterprise values to the decline. Therefore, other research, such as Ball and Watts, shows that accounting conservatism complies with management investment decisions, thereby helping to reduce agency problems. On the other hand, CEOs have a sensitive structural position at the top position of the organization and play an important role in shaping strategic decisions. Therefore, it is more important to examine the ability of CEO in recent years. As a result, it can be said that the ability of the CEO does not have a positive and significant effect on conditional conservatism, but has a positive and significant effect on unconditional conservatism.

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