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BOARD GENDER DIVERSITY AND ACCOUNTING CONSERVATISM: EVIDENCE FROM FINLAND

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Abstract

The objective of the thesis is to investigate the relationship between board gender diversity and conditional accounting conservatism in Finnish context. There is relatively less literature on the effect of board gender diversity on accounting conservatism in comparison with literature on the relationship between the two board attributes - board size and board independence and accounting conservatism. With the global movement of women’s right in economic and social activities, female directorship’s representation on boards has also grown steadily worldwide. Accordingly, studies on gender differences and the effect on firm values of board gender diversity have increased.

Women are less likely to engage in actions regarded as unethical and they are more sensitive to ethical issues as well than men. Besides, women tend to be more risk-averse and less overconfident compared with men. The findings of empirical studies about the relationship between board gender diversity and firm financial outcomes are mixed. However, there are researches proving that boards are more effective in monitoring with the increase of women representation on boards. Therefore, I argue that boards with female directors are more likely to employ conservative accounting practices with the purpose of monitoring management more effectively.

In the part of empirical test, I utilize the incremental coefficient on bad news in Basu (1997)’s regression model to measure conditional accounting conservatism. The percentage of female directors on the board is used to measure board gender diversity. Using a modified Basu (1997)’s pooled regression model for OMX Helsinki 25 firms over the period 2009-2014, I find no significant effect of board gender diversity on conditional accounting conservatism.

Key words

Accounting conservatism, Board gender diversity, Corporate governance, Board of directors
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1 INTRODUCTION

1.1 Background

Corporate governance refers to “the system by which companies are directed and controlled” (Cadbury 1992). Essentially, it comprises a series of mechanisms for balancing the interests of many stakeholders, for example, including shareholders, management, employees, creditors, suppliers, government and the board of directors. Corporate governance has attracted increased attention in recent years following the high profile accounting fraud bankrupted companies such as Enron and WorldCom and subsequent the introduction of the Sarbanes-Oxley Act in 2002 in the U.S.. Investors’ confidence to financial reports has been weakened a lot due to those accounting scandals. Regulators, practitioners and academics have put great efforts on developing more sophisticated accounting practices in order to recover investors’ confidence in financial reporting. Conservative accounting practices, for example, are encouraged by many researchers to improve the credibility of financial reporting. And there are also dozens of studies concentrating on exploring the relation between corporate governance and accounting conservatism. Lara et al. (2009) find that a positive association between governance and accounting conservatism. Ahmed and Henry (2012) document similar finding that voluntary corporate governance has a positive influence on conditional accounting conservatism. But Chi et al. (2009) indicate a quite opposite view that firms with weaker governance structure tend to be more conservatism and their empirical results are consistent with the opinion that conservatism is a substitute for other corporate governance mechanisms.

Conflicts of interest between managers and other parties of the firm are mitigated through corporate governance mechanisms such as board of directors, institutional shareholders and managerial ownership, in a world with incomplete contracts. The board of directors, as the central of corporate governance, no doubt is a subject that has been studied intensively. It performs the most important internal monitoring role in a company. Fama and Jensen (1983) refer to the board of directors as the apex of an organization’s monitoring and control system. Directors have the power to hire and fire managers, determine the compensations for managers, and approve the key decisions such as the acceptance of major investment projects. Directors also advise
managers on proposed strategies and provide outside expertise. And there is no doubt that director in the board need verifiable information in order to effectively monitor and advise managers. The accounting and financial reporting system is a critical source of verifiable information that is useful in monitoring and evaluating managers as well as their decisions and strategies. And the board of directors is expected to insist on higher reporting quality. Basu (1997) and Watts (2003) support the assertion that accounting conservatism is one of the most important attributes of higher accounting quality. Accounting conservatism has evolved as part of an efficient contracting technology that helps boards of directors in reducing deadweight losses resulting from agency problem, according to Watts (2003) and Ahmed and Duellman (2007). Consequently, a growing body of research studies the association between the board of directors and accounting conservatism. For example, Beekes et al. (2004) documents a positive relation between board independence and conservatism for a sample of UK firms. Ahmed and Duellman (2007) investigate the relation between accounting conservatism and board independence and the strength of outside directors by using board of director characteristics as proxies. They document that an effective and independent board is more likely to utilize accounting conservatism to monitor managers.

The effectiveness of the board of directors depends on various factors such as board size, board independence, the qualifications and experience of board members, et al. Although the board composition has long been discussed and disputed, there is a little consensus concerning what a board should look like (Johnson et al. 2013). Prior researches have focused on the size and independence of boards of directors. In fact, there is a growing literature that investigates the composition of directors’ demography, human capital and social capital (Johnson et al. 2013). Recent decades, diversity of board of director has been a hot topic in the public disclosure. For example, most of Corporate Governance Codes in Nordic countries recommend a diverse composition of a board with both genders represented, diverse background, experience and competences. Board diversity can be measured from several dimensions: gender, age, nationality, education background and industrial experience, et al. And among the studies of diversity of board of directors, board gender diversity gets particularly more attentions. Boards around the world are under the pressure to increase gender equality in the boardroom, which result in that female
representation on corporate boards in a number of major markets has increased steadily in recent years. According to 2014 Spencer Stuart Board Index\(^1\), females account for 30% of all new appointed directors among some of the largest companies in the United States in 2014 and this percentage is double than the percentage in 2009. Women comprise nearly 30% of all non-executive board members in UK in 2014. In Europe, gender diversity of boards has also increased substantially in recent years. On average, more than 20% of directors are women on the boards in European countries based on The 2014 European Board Diversity Analysis. And the top five countries with highest level of representation of women on boards worldwide are all from Europe. It is noteworthy that the process of increasing the percentage of women on company boards in Nordic countries is more outstanding compared with the rest of world. For instance, Norwegian listed companies continue to report the highest representation of women on the boards in the world, with an average of 38.9%, followed by Finland (32.1%), France (28.5%), Sweden (27.5%) and UK (22.6%). (Smelt et al. 2014)

Globally, the most common approaches taken by governments in order to increase female representation on corporate boards are quotas through legislation and the “comply or explain” governance system. The significant increase in the number of women on corporate boards in Norway attributes to gender quota system in which all the listed companies must abide to buy a 40% gender quota for female directors or face delisting. In France, a law requiring French companies to raise the percentage of women on board to 40% by 2016 was passed by the low house of the French parliament in 2010 (Zhou 2012). Most of European countries have adopted the “comply or explain” system to addressing the disproportionality on corporate boards. The “comply or explain” system requires companies to address the issue of proportionate gender representation in terms of board of directors and executive appointments, and if not, to explain why. In Finland, a hybrid approach which combine a “comply or explain” system and a quota to guarantee both gender to be represented on every company board. However, it is not surprising that there are also many major economies such as Japan, South Korean, Russia, and China, where men

\(^1\) Spencer Stuart Board Index provides a comprehensive review of governance practice among leading public corporations in various countries, regions and industries around the world.
still absolutely domain economic activities, making little progress in gender diversity in boards (Smelt et al. 2014). In addition, many firms appoint female board members because they are under societal pressure for greater equality of the sexes. Commonly, there is only one female director on their boards, which is the evidence of tokenism (Adams and Ferreira 2009).

1.2 Previous Literature

Accounting conservatism, as one of the most important features of accounting information, has a very long history. (Basu 1997, Watts 2003a) And it has impacted accounting practice long and significantly (Sterling 1970, Watts 2003a). There are many different interpretations with regard to accounting conservatism. The convention of conservatism is known as a policy of anticipating possible losses but not gains. More officially, some researchers and standard setters define accounting conservatism as policies which tend to understate accounting net asset value relative to economic net asset value (Beaver & Ryan 2005, Ruch & Taylor 2015, FASB 1980).

Accounting researchers have identified two broad forms of conservatism: (1) conditional conservatism, and (2) unconditional conservatism. Conditional conservatism, also known as ex-post conservatism, earning conservatism and information-driven conservatism, refers to writing down book value under sufficiently adverse circumstances but not writing up them under favorable circumstances (Beaver & Ryan 2005). Another well-known interpretation to condition conservatism is published in Basu (1997)’s modern research literature. Basu (1997) defines it as the asymmetric recognition of earnings in losses relative to gains. He predicts that earnings is more timely in reporting “bad news” as measured by negative stock return, than “good news” as measured by positive stock return. Following Basu (1997)’s paper on conditional conservatism, academic researchers have extended this research area widely. Ball et al. (2000) explore the difference of accounting conservatism in international contexts across different GAAP regimes by applying Basu (1997)’s measure of conditional conservatism. The empirical results
show that the asymmetry in recognition in earnings of bad news relative to good news is more pronounced in common-law countries than in code-law countries. In addition, there are studies extending to investigate the effect of accounting conservatism on the financial statements since Basu (1997) has started it. According to Ruch and Taylor (2015), these studies focus on evaluating how accounting conservatism affects earnings quality, including earnings persistence and the presence of earnings management. Unconditional conservatism, also labeled as ex-ante conservatism and balance sheet conservatism. The application of unconditional conservatism is not driven by economic news, unlike the application of conditional conservatism. An example of unconditional conservatism is R&D expensing. Usually, most of R&D investments are recognized as revenue expenditure but not an asset, even though they may generate economic rate of return. The resistance of the capitalization of R&D is one of extreme cases of conservative accounting practices. (Mora & Walker 20114)

In fact, the existence of accounting conservatism has been debated a lot among researchers and standard setters. Some researchers advocate that neutrality should be a desirable feature of financial accounting information. The Financial Accounting Standards Board also support that view and stresses the importance of neutrality as an aspect of financial accounting information. It believes that conservatism as an accounting principle bias accounting information. (FASB 2010) On the other hand, some researchers defend the existence of accounting conservatism by advancing a number of explanations for the origin of conservative reporting.

Contracting explanation for conservatism origin has been developed for a long time (Watts 2003a). Many researchers contend that accounting conservatism as an efficient contracting mechanism is necessary to contracting parties. Frankly, a firm is constructed as a nexus of contracts among contracting parties. The main contracting parties are managers, shareholders and debtholders, who have been also identified as the main users of financial statements. And two primary types of agency problems in a firm arise among the three main contracting parties. The first agency problem occurs because of the interest conflict between managers and shareholders. Under executive compensation contracting, managers have information advantage over shareholders and the two contracting parties have different horizons on firm
performance and asymmetric payoffs as well. All of those may lead to managers’ self-interested behaviors happen. Conservative accounting recognizes losses in a timelier manner than gains, which constrain managers’ tendency of maximizing their own compensations through biasing accounting numbers. (Blunck & Rego 2013) Another important agency conflict in a firm is between shareholders and debtholders. And accounting conservatism plays a critical role in reducing the conflicts between shareholders and debtholders since it benefits both of the contracting parties (lenders and borrowers) according to some empirical results. On the one hand, conservatism provides lenders with more timely signals of bad news and enables them to take necessary actions to protect their interests. On the other hand, from borrowers’ point of view, conservatism reduces the cost of debt (Beaver & Ryan 2000, Ahmed et al. 2002).

The rest explanations for accounting conservatism, according to Watts (2003a), are litigation, tax and regulation. Litigation as a factor that induces managers to adopt conservative accounting practices can be explained by empirical evidences that conservative accounting results in less litigation costs (Blunck 2009, Watts 1993). Taxation is also a determinant of accounting conservatism. Kim and Jung (2007) and Diang (2007) both find that taxation induces unconditional conservatism. Financial accounting standard setter and regulators also require accounting conservatism because conservative accounting practices help them reduce criticism and the political costs.

The measures of conservatism can be summarized into three categories: net asset measures, earnings and accruals measures and earnings/stock returns relation measures. Book-to-market ratio and valuation models are two common net assets measures of accounting conservatism. Under conservatism, book value of net assets is understated owing to the asymmetric recognition of gains and losses, and which in turn, inducing book-to-market ratio become lower. (Beaver & Ryan 2000) Valuation models, based on the studies of Feltham and Ohlso (1995, 1996) capture the degree of understatement of net assets. Earnings and accruals measures are the second types of conservatism measures. Losses are recognized in earnings quickly and completely than gains under conservatism principle. Thus, losses tend to be fully accrued while gains do not, which induces negative periodic accruals and understated cumulative
accruals. Accruals as a part of earnings, Givoly and Hayn (2000) suggest that the sign and magnitude of accumulated accruals can be measures of conservatism as well. The third types of accounting conservatism measures are earnings/stock returns relation measures. Basu’s earnings measure (the incremental coefficient β1 on bad news) captures the difference in sensitivity of earnings reflecting negative stock returns against positive stock returns and has been widely applied for measuring the degree of conditional conservatism in academic researches on accounting conservatism.

Corporate governance the process of supervision and control which guarantee management of a firm acts in accordance with interests of shareholders (Parkinson 1994). And it handles with a set of relationship among stakeholders of the firm such as shareholders, managers, board of directors and creditors, et al. The relationship between shareholders and executives exists in the central of corporate governance. The agency conflicts between managers and shareholders arise from the separation of ownership and control. And monitoring and incentives are two solutions that tend to reduce the conflicts between shareholders and managers.

The board of directors on behalf of shareholders acts a central role in monitoring the behaviors of managers and the performance of management. In the light of the important role of the board in a corporation, the election of board members is very strict. A broad set of criteria, including independence, size, professional qualification, experience and diversity has been recommended or required in corporate governance codes or other acts. Board independence and board size are two most common board features that have been discussed and explored in literatures on board composition. Board independence has been perceived as one of extreme important characteristics that ensure the effectiveness of board of directors. Kim et al (2010) indicate that shareholders and regulators generally believe that the more independent the board is, the more objectively it evaluates the performance of management and the more effectively it monitors management. Studies that tend to link board independence to firm performance are considerable. However, no significant relationship between board independence and firm performance has been found (Dalton et al. 1998, Weisbach 2003, Johl et al. 2015). Many studies exploring the relationship between board independence and accounting conservatism find that board independence is
positively associated with conservatism (Ahmed & Duellman 2007, Beekes et al. 2004, Kankaanpaa 2009). Board size is another factor determining the effectiveness of a board, which has been studied intensively. The right size for a board depends on many elements and should be driven how effectively the board is able to operate as a team (Conger 1998). Studies on the relationship between board size and firm performance presents conflicting findings. Based on my literature review, three researches report a negative relationship between board size and firm performance (Yermack 1996, Hermelin & Weisbach 2003, Guest 2009, but four studies document contrary results (Dalton et al. 1999, Andre & Vallelado 2008, Shukeri et al. 2012, Johl et al. 2015). Studies that attempt to link board size and accounting conservatism are limited. Boussaid et al. (2015) and Ahmed and Henry (2012) find that board size are negatively related to the degree of conditional conservatism. But Ahmed and Duellman (2007) find no relation between conditional conservatism and board size.

Beside board independence and board size, board diversity that consists of a broad spectrum of demographic attributes like gender, age, educational backgrounds and ethnic backgrounds has also received more and more attentions in recent decades. Baker and Anderson (2010) conclude several benefits and costs that board diversity can bring to a board. Diversified board means more diversified resources and connection with the external environment and means the collision of disparate ideas. Furthermore, diversity benefits board with enhanced reputation, legitimacy and investor relations. However, too many dissimilar views in a board could cause more conflicts and insufficient communication as well. And it is one of costs that diversity can produce. Another cost of diversity is tokenism. There are a few of studies on the relationship between board diversity and firm performance and they present mixed results. Among those studies, lots of researchers tend to use gender and race diversity to define board diversity. And generally both significant positive relation and insignificant relation between board diversity and firm performance are found. (Carter et al. 2003, Kim and Lim 2010, Kochan, 2003)

Women’s representation on boards in the worldwide has increased in recent years. Moreover, gender diversity of a board attracts most of attentions in the empirical studies of board diversity. Current literatures on board gender diversity agree that more women’s representation on a board leads to more an active board. Adams and
Ferreira (2009) argue that male directors have much severe attendance problems than female directors. Terjesen et al. (2009) find that gender diversity has an impact on board dynamics. The presence of women on boards improves board effectiveness, according to Nielsen and Huse (2010). Studies exploring the effect of board gender diversity on firm-level outcomes document mixed results. Srinidhi et al. (2011), Campbell and Minguez-Vera (2008) and Carter et al. (2003) find a positive relationship between board gender diversity and measure of firm performance. However, Böhren and Ström (2005) find an inverse relation between the percentage of women on boards and Tobin’s Q. And there are researchers who fail to find any significant association between board gender diversity and firm financial performance (Shrader et al. 1997).

Gender differences in regard to ethical behavioral and risk attitudes in the context of money and finances provide me with incentives to study the relationship between board gender diversity and accounting conservatism. According to my literature reviews, current evidences on the effect of board gender diversity upon accounting conservatism are inconclusive and insufficient. Zhou (2012) and Boussaid et al. (2015) both find a positively relationship between board gender diversity and accounting conservatism. But Sultana and Van der Zahn (2011) report a contrary result that firms with female directors are associated with less accounting conservatism based on Australian data.

1.3 Research Problem Discussion

Global movement of women’s right promotes gender diversity to be the most debated board diversity issue. Generally, the value of the presence of women on boards is recognized by businesses and academics. Women may enhance shareholder value through bringing additional perspective to board decision-making (Campbell and Minguez-Vera 2008). Female directors are less likely to engage in actions regarded as unethical and are more risk-averse (e.g. Betz, O’Connell and Shepard 1989, Bernardi and Arnold 1997, Cohen et al. 1998). Accordingly, the influence of board gender diversity is explored extensively. Most of studies focus on linking

Whereas the relation between the independence of board of directors and conservative accounting practices, and the economic consequences of corporate boards gender diversity, have been intensively explored by previous studies (e.g. Ahmed and Duellman 2007, Beeke et al. 2004), the link between board gender diversity and accounting conservatism has not been investigated so much. Female directors present stricter monitoring, according to Adams and Ferreira 2009). And Gray and Nowland (2010) show that female directors are more independent in thinking and less likely to belong to old boys’ network, which can be seen as the evidence that gender-diverse boards enhance board independence. This thesis therefore aims to investigate whether board gender diversity is a source of conservative accounting practices. And I address this issue based on the empirical analysis of data from Finnish listed companies.

Finland, as one of countries with very high representation of women on board of directors in the world, is generally considered one of pioneers in gender equality. In Finnish listed companies, the number of female board members is governed by recommendations of the Corporate Governance Code. The CG Code applies mainly the self-regulation approach to improve gender parity in the listed firms. And the mode of self-regulation has been proven to achieve significant development in promoting gender equality based on the fact that the number of female board members in Finnish listed companies has tripled during the last ten years. Beside the
self-regulation approach, the Finnish government may consider taking legislative measure to ensure a more equal gender representation on the board of listed companies if the improvements of gender parity in listed companies’ boards are insufficient. Further, with regard to other measures in Finland to improve gender equality, there are business organizations and education facilities providing women with mentoring or educational programs in order to assist women in developing experience and confidence in preparation for leadership positions. In the view of the development of board gender diversity in Finland, It is encouraging and interesting to investigate the real situation of female directors’ representation in Finnish listed companies. In addition, examining the effect of board gender diversity on accounting conservatism based on Finnish data may generate relatively reliable results due to the fact that Finland is one of countries which have not imposed statuary requirements specifying the number of female directors on a board.

In short, the purpose of my thesis is to increase the knowledge of the effects of board gender diversity upon conditional conservatism. And in practice, it may delivery some inspirations on how to select board members when women representation on boards should be taken into consideration. The study makes contributions to the literature on the demography of the board composition.

1.4 Thesis Structure

The structure of this thesis is organized into seven chapters. This chapter has presented the background, prior related researches and the research problem of the thesis. In Chapter 2, the definition of accounting conservatism is firstly introduced. Then, four explanations for the origin of accounting conservatism are discussed. Finally, Chapter 2 focuses on the measures of conservatism, and especially, Basu’s measure for conditional conservatism is emphasized and presented. Chapter 3 presents theories related to corporate governance. And concepts relevant to the board of directors, typically known as the center to corporate governance are addressed. Particularly, gender diversity in terms of the board composition is explained in Chapter 3. Chapter 4 develops the link between conservatism and board gender
diversity and the hypothesis is put forward for the study. Chapter 5 presents the research design. Chapter 6 discusses how the data is collected and analyzed. And the last chapter draws the conclusions and discusses the limitations of the research.
2 ACCOUNTING CONSERVATISM

2.1 Conservatism Defined

Conservatism, as the most influential principle of valuation in accounting, its influence on accounting practice has been long and significant (Sterling 1970, Watts 2003). Basu (1997) even argues that conservatism has affected accounting practice for at least 500 years. In the last few decades, the debates surrounding accounting conservatism have appeared to increase. The early definition of accounting conservatism can date back to the adage: “anticipate no profit, but anticipate all losses” (Bliss 1924), also known as the conventional explanation to accounting conservatism. In the later empirical literature, Basu (1997) interpreted the adage as the accountant’s tendency to require higher degree of verification to recognize good news as gains than to recognize bad news as losses. In other word, conservatism is the asymmetrical verification requirements for gains versus losses. However, Beaver and Ryan (2005) defines conservatism as the on average understatement of the book value of net assets relative to their market value. Accounting standard setters have defined conservatism principle similarly as follows:

“Conservatism is a prudent reaction to uncertainty to try to ensure that uncertainties and risks inherent in business situations are adequately considered. Thus, if two estimates of amounts to be received or paid in the future are about equally likely, conservatism dictates using the less optimistic estimate…” (FASB 1980)

But the application of conservatism in financial reporting has recently become a highly controversial issue. And different perspectives on the informational roles of accounting induce a debate on conservatism versus neutrality as a desirable feature of financial accounting information (Ruch & Taylor 2015). Some researchers argues that accounting conservatism arises naturally between contracting parties and it is required by contracting parties to guarantee the efficiency and effectiveness of contracting settings. And the origin of accounting conservatism that is explained from contracting and the other three perspectives will be explicitly stated in the following subsection. Alternatively, some researchers contend that conservatism
biases financial statement numbers, thereby resulting in inefficient investment decisions. Because from theirs’ perspective, the primary function of accounting is to capture information for assessing the market value of equity precisely and making investment decisions. The concept of prudence (conservatism) as part of the qualitative characteristics of financial statements was included in The Conceptual Framework issued by the International Accounting Standards Committee (IASC) in 1989. However, the most recent version of the Financial Accounting Standards Board (FASB) has omitted conservatism as a desirable qualitative characteristic of financial reporting information in its conceptual framework (FASB 2010). Rather it states that conservatism is incompatible with neutrality and biases accounting information.

2.2 Explanations for Conservatism

The generation of accounting conservatism can be explained from four perspectives, according to Watts (2003a). The number one source of conservatism is contracting explanation.

2.2.1 Contracting Explanation

Contracting explanation is an early source of conservatism. So arguments on it are more fully developed comparing to other three explanations. The contracting explanation for conservatism origin is that shareholders and debtholders demand conservative financial reporting from managers to reduce agency costs and to align managerial incentive with those of shareholders. And Watts (2003a) divides the contracting explanation into three distinct theories: executive compensation contracts, debt contracts and governance.

Agency theory suggests that the firm can be regarded as a nexus of contracts. An agency relationship arises when agents are employed to manage a firm or perform some services for principals and the authority of decision-making is delegated to the agents. Basically, there are two primary agency relationships in business: the
relationship between stockholders and managers and the relationship between stockholders and debtholders. Accordingly, the employment contracts between managers and a firm and the debt contracts between a firm and debtholders are the two main types of contracts in the firm. Agency theory is concerned with conflicts of interest between principals and agents. First of all, there is a potential conflict of interest between managers and shareholders. Because of information asymmetry and uncertainty, managers who administer a firm on behalf of shareholders may operate the firm in their own self-interest rather than in the best interest of shareholders. In order to mitigate the conflict between managers and shareholders, monitoring and compensations are two main methods to encourage managers to act in the shareholders’ best interest. Usually compensation contracts are linked to managers’ performances as defined by accounting measures like earnings. Additionally, limited horizons and asymmetric payoffs exist in a firm. For instance, managers generally are shorter-horizon than shareholders are. Managers’ payoffs are more tightly associated with short-term performance while shareholders consider more long-term values. Therefore, under this circumstance, self-interested behaviors may occur since managers have both possibilities and incentives to bias accounting numbers in order to maximize their own compensations. Conservatism accounting requires managers to recognize bad news in accounting earning in a timelier manner than bad news. So managers are less likely to be compensated for uncertain returns and at a certain degree, conservatism prevents managers from biasing earning upwards to increase their compensations. (Blunck & Rego 2013)

In addition to the agency conflicts between managers and shareholders, there is a second kind of agency conflicts – the agency conflicts between shareholders and debtholders. This potential agency problem exists since creditors’ main concern to decide to whether lend capital to a corporation or not is the future cash flow that is affected by the riskiness of the company, its capital structure and its potential capital structure. Shareholders, however, have main control of operating decisions that affect the potential future cash flow through managers and shareholders will act based on their best interests. In order to solve the agency problem and protect the interests of lenders, some financial protective covenants such as limited dividend payout covenants are agreed in the debt contracts between lenders and borrowers. And conservatism plays an important role in the debt agreements. On the one hand,
conservatism benefits debtholders since conservatism enables debtholders to get timely disclosure of bad news and timely losses recognition will trigger covenant violations more quickly. Accordingly, debtholders could take necessary actions to protect their interests in time or obtain corresponding compensations due to the violations of the firm. On the other hand, borrowers will benefit from conservatism as well since the more conservative they are, the lower borrowing rate they receive, according to Beaver and Ryan (2000), which means conservatism has a function of reducing cost of debt. Ahmed et al. (2002) also indicates that conservatism is associated with a lower cost of debt when other determinants of firms’ debt costs are under control.

The contracting governance theory suggests that conservatism providing timely bad news ensures shareholders monitor managers more effectively. In other words, shareholders are better able to correct problems and to induce managers when they receive bad news in a timely manner. For instance, conservative accounting will speed up the recognition of losses when managers take negative net present values projects. And timely signals for investigating the existence of negative net present value projects provided by conservative accounting could lead to shareholders take appropriate actions such as discharging managers or eliminating the projects in order to protect their interests. Blunck & Rego (2013) predict that stronger corporate governance is associated with more accounting conservatism. However, they find that there is limited evidence consistent with the governance theory.

2.2.2 Litigation Explanation

Litigation, as one of other explanations for accounting conservatism, unlike the contracting explanation, only has been developed recent decades since before 1960’s, litigation under the Security Acts was relatively rare. However, litigation explanation for requiring managers to report conservatively has received more attentions with the increasing lawsuits of firms. Under the securities litigation law, firms’ managers, directors or auditors can be sued by shareholders when frauds or misstatements exist in the financial reports and shareholders’ interests get damaged. And shareholders’ litigation costs including attorneys’ fees, settlement payments and reputational penalties are usually significant. Conservative reporting can lead to net assets and
earnings are understated, which directly reduces the likelihood of litigation (Watts 1993). Accordingly, the litigation explanation for conservatism is that managers have incentives to report conservatively in order to reduce the firm’s litigation costs. Blunck (2009) also explains that conservative accounting defined as the asymmetrical timeliness in the reporting of good news against bad news could ensure bad news to be disclosed in a timely manner and prevent misleading good news to be reported. Thus, conservative accounting should result in less litigation.

Blunck (2009) find that higher litigation risks are associated with more conservative financial reporting, which is consistent with the prediction that accounting conservatism increases in US firms when litigation risks are getting higher in US legal environment from Watts (1993). Besides, Blunck (2009) provides convincing evidence that reporting more conservatively lowers a firm’s litigation costs. All in all, accounting conservatism and litigation are tightly associated and their association is mutual.

2.2.3 Tax Explanation

Taxable income has long been linked to reported income and the link between them provides an incentive to defer income to decrease the present value of taxes (Watts 2003a). And conservatism defined as asymmetric recognition of losses and gains in earnings enables managers to report lower earnings through delaying reporting unrealized revenue but recognizing anticipated losses timely. Consequently, tax liability will be reduced owing to conservative financial reporting.

There are a few of studies intending to investigate whether taxation is a determinant of accounting conservatism. Kim and Jung (2007) examine the effect of taxation on conservatism and find that conservatism is positively related with a firm’s tax burden by using unconditional conservatism measures. However, the relation is not found under a conditional conservatism measure, suggesting that the choice of conservatism measures influence results of empirical studies on the relation between conservatism and taxation a lot. Kim and Jung (2007) also explain why unconditional conservatism measures are more suitable for detecting tax motivated conservatism. They use an example of conditional conservatism that impairment losses of fixed
assets that are generally not tax-deductible to compare with R&D expenses, a main component of unconditional conservatism that are deductible for tax purposes in general, which shows that taxation seems to be more closely associated with unconditional conservatism. Qiang (2007) examine whether each proposed explanation for accounting conservatism applies to conditional conservatism, unconditional conservatism, or both and find a consistent result with Kim and Jung’s that taxation induces unconditional conservatism.

2.2.4 Regulation Explanation

The last explanation for conservatism accounting suggested by Watts (2003a) is regulation explanation. The regulation explanation is that being conservative to report firms’ financial statements could be required by accounting regulations. The phenomenon that losses from overvalued assets and overstated income are more observable in the political process than gains owing to undervalued assets and understated income provides incentives for standard setters and regulators to be more conservative, according to Watts (1977).

The governmental regulation for financial reporting has started from the establishment of the Securities Acts in 1930s, which is to prevent firms from overvaluing their stock. After that, the Securities and Exchange Commission (SEC) has also drafted a set of regulations to prohibit firms to overstate their net assets value. And the most recent regulation example to indicate the regulation explanation for conservatism is Sarbanes-Oxley Act (SOX). SOX is known as an United States federal law that set new or expanded requirements for all U.S. public company boards, management and public accounting firms. It was enacted as a reaction to number of major corporate and accounting scandals like Enron and WorldCom. SOX, as a stricter financial governance law, ensures public company certifying the accuracy of financial information and increases the oversight role of board of directors and the independence of the outside auditors. Besides, SOX imposes much more severe penalties on firms which engage in fraudulent financial activities. There are research findings suggesting that firms’ financial reporting tends to be more conservative after SOX act has been published. For example, Lobo and Zhou (2006) find that firms report lower discretionary accruals after SOX than in the period
preceding SOX and when firms report income in the post SOX-period; losses are recognized quickly than gains.

2.3 Conditional Conservatism versus Unconditional Conservatism

Accounting scholars have concluded that there are generally two types of conservatism recognized in the literature: conditional conservatism and unconditional conservatism.

Conditional conservatism refers to, according to Beaver and Ryan (2005), writing down book values under sufficiently adverse circumstances but not writing up them under favorable circumstances. One example of conditional conservatism is writing down physical assets to reflect impairments or obsolescence, but not revaluing them upwards. This definition actually is consistent with traditional defined accounting conservatism and Basu (1997)’s interpretation to it. Basu (1997) interprets conditional conservatism as capturing accountants’ tendency to require a higher degree of verification for recognizing good news than bad news in earnings. In Basu’s regression model of earnings on unexpected returns, negative stock return is used as a proxy for “bad news” and positive stock return proxies for “good news”. And the prediction to the association between earnings and returns under conservatism is displayed in Figure 1 below.

Figure 1. The relation between earnings and stock returns under conditional conservatism (Basu 1997)
$E_i$ and $R_i$ are earnings and stock returns respectively, for firm $i$ in year $t$. The slope of coefficient for negative returns is predicted higher than the slope of coefficient for positive returns, which means that earnings, under conditional conservatism is predicted to be more strongly associated with concurrent negative unexpected returns (bad news) than with concurrent positive unexpected returns (good news). The regression results are consistent with Basu’s predictions that earnings is more timely in reporting publicly available “bad news” than “good news”, as measured by the difference in either the slope of coefficient or the adjusted $R^2$ s for bad and good news.

Following Basu’s (1997) seminal work, in the accounting literature, the Basu coefficient to measure conditional conservatism is used extensively, although Basu’s measure has been criticized since stock returns, as proxies for good/bad news, introduces inaccuracy in the measure of conditional conservatism. And the concept of conditional conservatism has stimulated considerable researches and has brought new insight into financial reporting since Basu (1997) developed it. Ball et al. (2000) apply the Basu’s interpretation of accounting conservatism in an international context, following its introduction in Basu’s (1997) paper. They find that accounting income reported in common-law countries like USA, UK and Canada is substantially more conservative than in code-law countries such as Japan, Germany and France. Therefore, they conclude that the properties of accounting earnings vary across the countries due to different legal and institutional factors. Their research paper is one of example researches investigating conditional conservatism in accounting as a function of countries’ political, legal and taxation regimes. Besides, researchers have also utilized the Basu measure to study the effects of conditional conservatism on earnings quality, to examine the role of accounting accruals, to study the relationship between conditional conservatism and corporate governance, management compensation, and so on and so forth.

Unconditional conservatism, also labeled as balance sheet conservatism (Richardson and Tinaikar 2004), means the understatement of assets and overstatement of liabilities (Watts and Zimmerman 1986). Belkaoui (1985) also claims that conservatism "implies that preferably the lowest values of assets and revenues and the highest values of liabilities and expenses should be reported". Givoly et al.
(2007) state that unconditional conservatism is the selection of “conservative” accounting methods. Comprehensive examples of unconditional conservatism in accounting practices are the adoption of accelerated depreciation, immediate expensing R&D costs, and the uses of LIFO inventory valuation. This type of conservatism introduces understatement of asset values by applying conservative accounting methods. Its effect on the balance sheet is persistently over time by systematically allocating the original acquisition cost over the life of an asset. And it doesn’t reflect new information about changes in assets values, which is exactly in contrast to conditional conservatism that asymmetrically recognizes new information about the current value of assets. (Basu 2001)

Both Conditional and unconditional conservatism give rise to understatement of the book values of net assets relative to the economics values. And the two aspects of conservatism have many of the same purposes, according to Beaver and Ryan (2005). Both types of conservatism help firms reducing litigation, regulatory and tax costs, and enable accounting standard setters and regulators to minimize the risks being criticized. However, the literatures on conditional and unconditional conservatism have different emphases. The literature on conditional conservatism focuses on improving contracting efficiency for the sake of protecting shareholders and other stakeholders’ interests and reducing deadweight losses arising from agency conflicts. The literature on unconditional conservatism emphasizes the valuation of certain types of assets and liabilities, in which observing their effects on future earnings. Ruch and Taylor (2015) state that a primary difference between conditional conservatism and unconditional conservatism can help distinguish the two broad forms of conservatism. Conditional conservatism is characterized by the asymmetrical recognition of positive and negative economic news. But unconditional conservatism occurs when accounting net assets consistently under-recognized. Put it simply, conditional conservatism depends on economic new events, while unconditional conservatism does not. This is why some commentators refer to conditional conservatism as ex-post conservatism and unconditional conservatism as ex-ante conservatism. Additionally, Ruch and Taylor (2015) summarize three important reasons to distinguish the difference between conditional and unconditional conservatism. The first reason is that the two distinct types of conservatism have varied effects on the financial statements.
unconditional conservatism has relatively consistent impact on the income statement from period to period compared to the application of conditional conservatism. Secondly, Beaver and Ryan (2005) develop a model to capture the different natures of and interactions between conditional conservatism and unconditional conservatism under uncertainty. They find that unconditional conservatism may preempt the application of conditional conservatism because of “accounting slack” created by unconditional conservatism. And their model provides support for the studies arguing that unconditional conservatism as measured by the market-to-book ratio reduces conditional conservatism as measured by asymmetric timeliness coefficient. Those researches suggest that one type of conservatism affects the other type. The third reason to have a clear understanding of the differences between the two forms of conservatism is that the explanations for the origin of conditional conservatism differ from those for unconditional conservatism. According to Qiang (2007), the two types of accounting conservatism play different roles in contracting, regulation, taxation and litigation—the four explanations for conservatism offered by Watts (2003a). She finds that contracting and litigation give rise to conditional conservatism, whereas unconditional conservatism arises in setting where litigation, regulation and taxation are high.

2.4 Measures of Conservatism

In the accounting conservatism literature, a variety of measures to assess whether conservatism exists is an interesting feature of this field (Watts 2003a, Wang et al. 2008). And Watts (2003b) concludes conservatism measures into three categories: net assets measures, earnings and accruals measures and earnings/stock returns relation measures. He also states that those accounting conservatism measures generally arise from the definition of conservatism and rely on the effect of conservatism’s asymmetric recognition of gains and losses on reported accounting numbers, especially net assets, earnings and accruals.

The first types of measures are net assets measures. And this type of measures grow out of unconditional conservatism’s definition and researchers indeed use net assets
to measure unconditional conservatism mostly. And actually, the principle behind net assets measures is quite comprehensive and straightforward. According to the definition of unconditional conservatism, decreases in asset values are recognized, whereas increases in asset values that are not sufficiently verifiable are not recorded. The asymmetric recognition of gains and losses results in book value of net assets is understated. Book-to-market ratio is famous net asset measure and is commonly used for measuring unconditional conservatism. It is based on the notion that *ceteris paribus*, firms using conservative accounting report lower net assets compared to its equity value and thus, book-to-market ratios of the firms are lower whilst. (Beaver & Ryan 2000) Other examples of net asset measures are valuation model measures. For instance, Feltham and Ohlson (1995, 1996)’s valuation models capture the degree of understatement of net assets through conservatism parameter estimates.

The second types of measures are earnings and accruals measures. Figure 2 and Figure 3 illustrate the example that Basu (1997) uses for explaining his predictions. The example exactly demonstrates that under conservative accounting, earnings respond to economic losses more completely and quickly than economic gains and positive earnings changes tend to be more persistent than negative earnings changes.

![Figure 2. Example of book value of a fixed asset under conservative accounting when estimates of remaining useful life of a fixed asset change (Basu 1997)](image-url)
Basu (1997) assumes that a fixed asset with original ten years production life has changes on estimates of remaining useful life. Straight line depreciation method is applied for the fixed asset and its original purchased book value is 70000€ and has zero salvage. Revenues and other expenses before depreciation charges assumed to be 41000€ in each year of the fixed asset’s life. Two kinds of changes regard to the new estimated production life of the fixed asset are assumed. One is “good news” that the fixed asset’s expected life is increased by three years at the end of the fourth year. Another one is “bad news” that the fixed asset only remains three years of production life at the end of the fourth year, which means its expected life is decreased by three years compared to its original estimated production life. Figure 1 exhibits the effect of the two kinds of changes on the reported book value of the fixed asset. Figure 2 presents the associated effects of the changes on net income. Figure 1 clearly depicts that lower depreciation is charged for each year over the new remaining life when “good new” happens. And reported net income of each year in the new remaining life becomes correspondingly higher because of reduced depreciation, as shown in Figure 2. In contrast, a systematic treatment would increase depreciation charges over the entire shorter remaining life when the expected production life of the asset becomes shorter. And the “bad news” in practice would lead to an impairment of the asset, which result in the book value of the asset drop sharply. In addition, at the same time, the impairment will be recorded in earnings,
which causes the concurrent reported earnings decrease dramatically. However, earnings recovers back immediately in the next accounting period. The “bad news” has no effect on earnings in the future periods. In short, earnings respond more strongly to “bad news” than to “good news” and earnings increases are more likely to be persistent while earnings decreases are more likely to be transitory. And Basu (1997) finds negative earnings changes have greater tendency to reverse in the next period than positive earnings changes, which is consistent with his prediction. The asymmetric persistence of earnings between bad new and good new periods are measures of conservatism as well.

Accruals are the part of earnings. With conservatism principle, losses tend to be fully accrued while gains do not, resulting in negative periodic accruals and understated cumulative accruals. Therefore, negative periodic net accruals and negative cumulative accruals accumulated over periods can be used as measures of conservatism. For example, Givoly and Hayn (2000) suggest that the sign and magnitude of accumulated accruals over time are measures of conservatism.

Earnings/stock returns relation measures are the third type accounting conservatism measures. Basu (1997) regresses annual earnings on annual unexpected returns and finds that the slope coefficient and the adjusted $R^2$ from the regression is higher for negative unexpected return for positive unexpected return, which indicates that earnings are more timely in reporting “bad news” than “good news”. In Basu (1997)’s regression, the interactive slope coefficient, $\beta_1$ measures the difference in sensitivity of earnings to negative and positive unexpected returns and indicates the degree of earnings conservatism. In my study, I will adopt Basu (1997)’s earnings/stock returns relation measure as a proxy for accounting conservatism.
3 CORPORATE GOVERNANCE

3.1 Corporate Governance Defined

A corporation is one of forms of business ownership. Generally in a corporation, shareholders provide capital in exchange for shares of stock. The shareholders then elect a board of directors to control major decisions on behalf of the shareholders. And the board appoints managers to handle daily operations of the corporation. While the shareholders own the corporation, managers control the corporation. In other word, the ownership and control of a corporation is separated. And agency problems arise when there is a separation of ownership and control in a corporation because managers may be tempted to use the firm’s assets for their own interests if shareholders cannot monitor the managers’ behavior effectively. Solutions to agency problems existing in modern corporations fall into two categories: incentives and monitoring. The incentive solution refers to align executive incentives with shareholders’. For the purpose of tying an executive’s wealth to the wealth of shareholders, executives usually receive stock options or restricted stock as a significant component of their compensation. The second solution addressing to the agency problems is to monitor the behavior of managers through several monitoring mechanisms such as the board of directors, auditors, etc.

![Figure 4. Separation of ownership, monitoring and control (Kim et al. 2010)](image_url)
Figure 4 illustrates the separation of ownership and control between stockholders and managers. In addition, it shows a variety of potential monitors existing inside the corporate structure, outside the structure, and in government. The board of directors, as representatives of shareholders, plays a monitoring role inside a public corporation and oversees the actions of corporate executives. Monitors outside the corporate structure include auditors, analysts, banker, credit agencies, and attorneys. They not only monitor manager’s activities but also supervise the actions of the board of directors. Governments also monitor business activities through laws covering securities, taxes, et al. For instance, The U.S. government has established The Securities and Exchange Commission (SEC) to regulate public firms. (Kim et al. 2010)

Generally, corporate governance deals with a set of relationship between a firm’s shareholders, its board, its management and other stakeholders (OECD 2004). It refers to a set of mechanisms to guarantee suppliers of finance of a corporation getting a return on their investment (Shleifer & Vishny 1997). Parkinson (1994) defines corporate governance as the process of supervision and control intended to ensure that company’s management acts in accordance with interests of shareholders. Good corporate governance, according to the principle of OECD (2004), should provide proper incentives and effective monitoring for management and the board to act in concert with interests of the company and its shareholders. Despite there is no single model of good corporate governance, the Green Paper on the EU corporate governance framework (2011) has identified three subjects which are the heart of good corporate governance. The first subject is the board of directors. The two others are shareholders and the “comply or explain” approach which allows companies adapt to their corporate governance practices to their specific situation. To some extent, corporate governance prevents managers and other parties to distribute assets of a firm inappropriate at the expense of the rest of stakeholders. Accordingly, it is a key element in enhancing investors’ confidence. The degree of confidence not only means a lot to an individual company, but also has economic significance across an economy as a whole.

Corporate governance’s essential problems arise from the separation of ownership and control. And the relationship between shareholders and management indeed is
the central part of corporate governance. However, this relationship is not the only issue that corporate governance involves. The governance issues can result from the conflicts between controlling shareholders and minority shareholders as well, for instance. Controlling shareholders could be individuals, family holdings, and other corporations, which have significant influence on corporate behavior. Minority shareholders commonly are individuals who may have highly concerned about fair treatment from controlling shareholders and management, although, usually they do not seek to exercise their governance rights. The relationships among all the participants in the governance system are intricate and they all have an impact on the long-term success of corporate governance. The governance and the decision making process of firms are also affected by other multiple factors including, for example, macroeconomic context, regulatory, culture, institutional environment, and business ethics. And the role of each of these participants and their relationships varies among countries due to the effects from those multiple factors. (OECD 2004)

The key components of corporate governance are business planning and internal controls. And besides accountability and relationships with stakeholders, internal controls also include risk management and performance monitoring (Barrett 2001). Risk management refers to the process of identifying, assessing and prioritizing risks that a firm is exposed to. It aims to assist organizations to minimize, monitor and control the impact of risks and to maximize the realization of opportunities. Put it another way, risk management increases the probability of organizations’ success and reduces the likelihood of failure through different strategies of managing risks. And risks that companies face usually can be categorized into three aspects: credit risk, market risk and operational risk. The strategies to manage those risks typically consists of transferring risks to another party, reducing the probability or negative effect of risks, and avoiding risks, et al. Performance monitoring, as its name implies is reviewing and monitoring management and the organization’s performance. It concerns that executives in the organization deliver required outputs and outcomes. The board of directors plays a central role in monitoring the performance of management.
3.2 Corporate Governance Regulation in Finland

The first Corporate Governance recommendation in Finland was issued in 1997 by the Central Chamber of Commerce and the Confederation of Finnish Industry and Employers. The recommendation clarifies the corporate governance practices applied by Finnish firms. In December 2003, Hex Plc, the Central Chamber of Commerce and the Confederation of Finnish Industry and Employers issued a Finnish “Corporate Governance Recommendation for Listed Companies” jointly. The openness of Finnish listed companies was increased greatly by the recommendation. And a Corporate Governance Code was produced by the Board of the Securities Market Association in 2008, which replaced the Corporate Governance Recommendation for Listed Companies issued in 2003. Finnish Corporate Governance Code 2008 further provided international investors with information on the corporate governance practices applied by Finnish companies. Furthermore, in 2010, the Securities Market Association updated the Code 2008 by taking changes in regulations and international development into consideration. (Finnish Corporate Governance Code 2010)

As a matter of fact, Finnish corporate governance closely resembles the corporate governance in other Nordic countries (Iceland, Sweden, Norway and Denmark). The Nordic capital market has integrated increasingly during the last decades. The corporate governance codes of Nordic countries share similar key features because of common Nordic approach and general international development. The Nordic corporate governance model is so called “Nordic model”, which differs in some aspects from Anglo-Saxon model and European Continental model. The working group of the self-regulatory corporate governance bodies of the five Nordic countries has summarized some common aspects of corporate governance in listed companies in the Nordic countries. The first key feature of Nordic corporate governance is the owners in command. For example, the role of annual shareholders’ meeting is essential in terms of Nordic corporate governance model. Shareholders in Nordic

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2 The Securities Market Association is a cooperation body established in December 2006. It consists of the Confederation of Finnish Industries EK (previously the Confederation of Finnish Industry and Employers), the Central Chamber of Commerce of Finland and NASDAQ OMX Helsinki Ltd (previously Hex Plc).
companies are empowered with strong powers through the Annual General Meeting (AGM). The Annual General Meeting is the highest decision-making body of a company. Additionally, major shareholders in Nordic companies not only participate in the General Meeting proceedings but only involve themselves in the company affairs by serving on the board. There should be at least two independent board members from major holders in all five Nordic countries. Therefore, major shareholders play an active role in the governance process in the Nordic region. Furthermore, shares with multiple voting rights, as an ownership control enhancing mechanism, are permitted in the Nordic companies’ acts. The second distinctive feature of “Nordic model” is strong minority protection. The Nordic corporate governance codes and companies acts protect minority shareholders strongly for the purpose of balancing the power of major shareholders. The Nordic companies must treat all shareholders equally. Each shareholder, regardless of the number or class of shares held, has the right to participate in the General Meeting and to vote on his or her shares. Shareholders who are not able to attend in person may exercise their rights by proxy. There are rules that minority of various size can block the majority the General Meeting decisions such as amendments of the Articles of Association, share capital alterations and mergers or demergers. Moreover, the individual shareholders who are relative far-reaching rights obtain additional minority shareholder protection. Thirdly, the Nordic corporate governance is characterized by the strictly hierarchical governance structure. The Nordic corporate governance structure lies between the Anglo-Saxon one-tier and the Continental European two-tier model. The great majority of the Nordic listed companies have entirely or predominantly non-executive boards. And CEO and chairman of the Board cannot be the same person. Further, the decision-making powers of the General Meeting limit the extensive decision-making authority assigned to the Board in certain matters. (Leppälä-Nilsson et al. 2009)

### 3.3 Board of Directors

A corporate governance structure combines controls, policies and guidelines that drive the company toward its objectives have been set as well as protect
stakeholders’ interests. A corporate governance structure is a combination of various mechanisms. The corporate governance system of the modern corporation can be factorized into two parts, namely: internal governance mechanisms and external governance mechanisms. The internal governance mechanisms consist of shareholder meetings, the board of directors and operating executives. The external governance mechanisms consist of the capital market, the public sector, legislation and the labor market. Board of directors is at the core of the corporate governance structure. As the shareholders’ agent, a board of directors handles major decisions and delegates responsibilities to executives who run daily operations of a corporation. And the board is the most vital internal monitor in a corporation. A board is a group of knowledge workers trying to work together to be on behalf of shareholders to govern and protect an organization. A board needs certain resources and capabilities if it wants to work effectively and to create best results for the organization they are in charge of. Those resources and capabilities that an effective group or team needs are knowledge, information, power, motivation and time (Conger 1998).

In general, the board of directors has four broad functions. First, the board has the right to hire or fire, and evaluate top management, and the position of CEO is the most important decision the board need to consider. Second, the board deals with operating proposals and major financial decision. Third, the board also provides corporate officers with expertise on management. Fourth, it is the board’s duty to make sure the accuracy of disclosure of the firms’ activities and financial condition. Boards are recommended to establish the subcommittees to handle a great deal of important board work. The most common board subcommittees are audit committee, compensation committee and nomination committee. The establishment of board committees makes the Board’s work more efficient. (Kim et al. 2010)

While there is a saying that the composition of the board has to suit for the company’s business, the election of board members is under strict regulations. A broad set of criteria for the election of board members are made or recommended in corporate governance codes or other acts. Those criteria usually include independence, size, professional qualification, experience and diversity, et al. However, the debate to what a good board is has never stopped in the academic field. And much of the research studying board composition has focused on board
independence and size, despite more recently, there is an increasing amount of research on board diversity in the academic pipelines. In order to explore explanations for board composition influence on firm value, generally two theoretical frameworks have been applied. Agency perspective has been the most often used theoretical framework in these studies. This perspective views boards performing an important monitoring role and provides strong support for the studies of board independence. But Carter et al. (2010) denied agency theory’s support for financial benefits of board diversity. An alternative to the agency perspective, resource dependence theory has been proposed (Pfeffer and Salancik 1978). From resource dependence theory’s perspective, directors are resource providers. They are important sources of advice, counsel and key connections with stakeholders. Various dimensions of board diversity may bring different linkages and resources to the board, leading to better board performance. This theory can uphold the studies of board diversity stronger (Carter et al. 2010).

The following subsections will introduce the concept of board independence and size in corporate governance mainly. Besides, board diversity, especially gender diversity will also be discussed as my thesis studies the effect of board gender diversity on accounting conservatism.

3.3.1 Board independence

The board comprises of executives and non-executives who are either independent or non-independent directors. Executive directors are full-time employees of the firm. Non-executive directors (outside directors) work on the part-time basis and they take an important role of monitoring both management and executive directors. The term board independence refers to the independence of board of members from the company itself. Board independence is one of primary issues pertaining to board quality and efficacy. Shareholders and regulators generally believe that a board has a higher fraction of outside directors is more objective at evaluating management and more effective at monitoring management. (Kim et al. 2010) The Finnish Corporate Governance 2010 recommendation 14 states that the majority of the directors shall be independent of the company in order to avoid conflicts of interests and the majority consisting of independent directors shall include at least two directors who
are also independent of significant shareholders. Additionally, the Finnish CG-recommendation 15 gives specific criteria to evaluate director’s independence. Commonly, board independence can be measured by many different indicators. The most used board characteristics that proxy for board independence are the percentage of outside directors, the ratio of outside directors to insider directors and CEO/chair separation.

A great deal of studies have attempted to link board independence to firm performance. Despite the advantages of having more independent directors are emphasized in the literature of board composition and in different corporate governance codes, lots of studies provide no evidence that there is a relationship between board independence and firm performance. Dalton et al (1998) used meta-analytical method to study the relationship between board independence and firm performance. During their studies, board independence is measured by five varied indicators. However, they find that none of the five indicators of board independence affects firm performance significantly. Hermalin and Weisbach (2003) further confirm Dalton et al. (1998)’s findings. They don’t find either that the proportion of outside directors, which proxy for board independence is correlated with firm performance. Similar findings are reported in Malaysia. Johl et al. (2015) conduct a study that examines the effect of board characteristics upon firm performance. They collect data from 700 public listed Malaysia firms. And the result of their study shows that board independence doesn’t affect firm performance. According to Weir & Liang (2001), the reasons for no relationship between board independence and firm performance can be explained from two aspects. On the one hand, outside directors are not full-time employed and they are most likely to have other work commitments. Therefore, outside directors may lack time and efforts to monitor the performance of the firm. On the other hand, outsider directors may lack expertise and knowledge relevant to the industry in which the firm is and they could have insufficient information when complicated and vital decisions are needed to make.

While no systematic relationship between board independence and firm performance is found, studies examining the link between board independence and conservatism present totally different results. For instance, Beekes et al. (2004) documents a positive relation between board independence and conservatism for a sample UK
firms. Ahmed and Duellman (2007) find strong and robust evidence of a negative relation between the percentage of inside directors and conservatism, and a positive relation between outside director ownership and conservatism, by conducting a study to examine the link between a broad set of board characteristics that reflect board independence as well as the strength of directors’ monitoring incentives and accounting conservatism. Ahmed and Duellman (2007)’s study uses a sample consisting of 306 firms out of the S&P 500 firms over the fiscal years 1999-2001. The positive relation between board independence and conservatism is also confirmed by the evidence from Finland. Kankaanpaa (2009) examines the relation between the board independence and earning quality which is proxied by earning timeliness and earning conservatism. Through analyzing the data collecting from Finnish publicly listed companies, he finds evidences supporting for the hypothesis that the timeliness of bad news reflected in earnings is positively related to the proportion of independent board of directors.

3.3.2 Board size

Board size seems to differ from one company to another. And the question of “what size of a board should be” seems not easy to answer. Because the right size of a board depends on many factors such as the size of the corporation, the depth and complexity of issues facing the corporation, the responsibilities that the board should carry out, et al. According to Conger (1998), the right size for a board should be driven how effectively the board is able to operate as a team. The right size for a board should be determined by the board itself rather than outside experts. Most of corporate governance codes don’t specify the number of board members. For example, Finnish Corporate Governance Code’s recommendation to the number of directors is that it is important that the board has sufficient numbers to discharge its duties in an efficient manner.

The arguments on the relationship between board size and firm performance show conflicting results. Yermack (1996) also documents a negative relationship between board size and Tobin’s Q and profitability as measurements of firm performance, by using data from large US industrial corporations. Hermalin and Weisbach (2003) also support Yermack’s finding that there is a negatively relationship between board
size and firm performance. Guest (2009) uses a large sample of UK listed companies to examine the impact of board size on firm performance and finds that there is an inverse relationship between board size and profitability, Tobin’s Q and share returns. However, using a meta-analysis, Dalton et al. (1999) reports a contrary result that board size is positively correlated with firm performance. This finding is confirmed by Andres and Vallelado (2008) and Shukeri et al. (2012) that larger boards are more efficient in monitoring and are associated with better financial firm performance. Similar findings are found in the study conducted by Johl et al. (2015) who argue that board size is positively associated with firm performance.

Jensen (1993), Lipton and Lorsch (1992) argue that large boards have more coordination and communication problems and there are more likely existing free-riders among board members. They suggest that inefficiencies outweigh the initial advantages from having more directors when board size increases beyond a certain point. In contrast, Dalton et al. (1999) argues that greater collective information that larger boards can bring in leads to higher firm performance. Although the existing literature on corporate boards has tendency to agree that smaller boards are more efficient and better at monitoring in comparison with large ones (Boussaid et al. 2015), there is limited research linking the relationship between board size and accounting conservatism. Boussaid et al. (2015) investigate the relationship between corporate board contributes and conditional accounting conservatism in French context and find that large board size diminishes conditional accounting conservatism. Whereas Ahmed and Henry (2012) find that decreasing board size are negatively related to the degree of conditional conservatism but are positively associated with unconditional conservatism. Ahmed and Duellman (2007) document no relation between board size and the asymmetric timeliness of earnings.

3.3.3 Board Diversity

Board diversity as a key to better corporate governance has been gradually perceived in corporate governance research. It tends to cultivate a broad spectrum of demographic attributes and characteristics, such as gender, age, educational and functional background, industry experience, race, in the boardroom. Conger and Lawler (2001) state that “the best boards are composed of individuals with different
skills, knowledge, information, power, and time to contribute.” However, true board diversity refers to adding diverse views and perspectives rather than merely adding people of diverse ethnic backgrounds.

Based on resource dependence theory, firms may gain access to different resources through selecting directors with different characteristics since the board is a tool to link a corporation with external environment. (Lynall et al. 2003). For example, directors with political connections may assist firms dealing with regulators and governments. Thus, one of potential benefits of diversifying the board is more diversified resources and connections with the external environment. Moreover, board members with diverse backgrounds and characteristics may bring in varied perspectives and ideas, which lead to tackling problems with a great range of different solutions. Diversified board members are believed not only to foster creativity in delivering solutions to problems, but also to reduce the risk of group thinking. People with different backgrounds and experiences are more likely to analyze problems in different ways and to raise more debates on making decisions. This more critical analysis of problems may lead to higher quality of decision-making. Another potential benefit of board diversity should be pointed out is enhancement of reputation, legitimacy and investor relations. A board having people from minority backgrounds, both genders presented and different age ranges deliveries internal and external stakeholders a positively signal that the organization put efforts on treating minorities fairly. Besides, board diversity conforms more with legal requirements and with the view of stakeholders like customers and shareholders. (Baker and Anderson 2010: 227-228)

Not surprisingly, the costs of board diversity do also exist. Demographically dissimilar directors share different values and espouse dissimilar views, which may cause more conflicts and insufficient communication among group members. Furthermore, one problem related to board diversity is tokenism. There is a possibility of neglecting other important characteristics when meeting demographic characteristics required by external stakeholders. (Baker and Anderson 2010: 228-229)
Studies on the relationship between board diversity and firm performance are limited. And the results of those studies are mixed and inclusive. Carter et al. (2003) find a significant positively relationship between firm value and board diversity which is defined as the percentage of women and ethnic minorities. Consistent with Carter et al. (2003)’s result, Kim and Lim (2010) investigate the relationship between the diversity of independent outside directors and the valuation of Korean firms. They find that the diversity of age, academic majors among independent outside directors is positively correlated with firm valuation and there also is a consistent positive relationship between firm valuation and the proportion of independent outside with government experience. However, Kochan et al. (2003) find insignificant relationship between race and gender diversity and business performance. Similar finding is reported in a study generated by Carter et al. (2010) that no correlation between gender and race diversity and firm performance is found in the US boards. In short, the effect of board diversity upon firm performance or valuation has been mostly documented as both significantly positive and insignificant. Nevertheless, little evidence supports a negative relationship between board diversity and firm performance (Kim and Lim 2010)

3.3.4 Board Gender diversity

Women hold a small number of corporate board seats. Women held 17.7 percent of Fortune 1000 board seats in 2014, up from 16.6% in 2013 (2020 women on boards, 2014). And the estimated percentage of female directors in Australia, Canada, Japan and Europe is even much lower, namely, 8.7%, 10.6%, 0.4%, 8.0% in 2004 (Adams and Ferreira 2009). However, women’s representation on boards has increased all the time in recent years. And the growing trend of the percentage of women on boards worldwide mainly depends on the promotions of nonprofit organizations and legislative initiatives. For example, in the United States, there is a national campaign called 2020 Women on Boards. It aims to increase the percentage of women on U.S company boards to 20% by the year 2020. Catalyst, a nonprofit organization, has Women on Boards initiative operating in Canada and the United States of America that promotes the appointment of women to corporate boards by selecting and pairing women corporate director candidates with mentors and champions. In Britain, The Higgs report 2003 and the Tyson report 2003 both call for increased
representation of women on British boards (Baker and Anderson 2010: 230-231). With regard to legislative initiatives to women on boards, Norway did the most extreme promotion that all listed companies must abide by a 40 percent gender quota for female directors or face dissolution (Adams and Ferreira 2009).

In the empirical studies of board diversity, the effects of board gender diversity have been explored most extensively. Johnson et al. (2013) review the research on board demographics and summarize that much of studies of directors’ gender take the stance that board gender diversity has impact on board dynamics, cognition and decision making and in turn, firm-level outcomes. In terms of the changes that women representation brings into boards, the existing literature agrees that more women on boards is correlated with more an active board. Adams and Ferreira (2009) suggest that female directors are significantly less likely to have severe attendances problems and male attendance become greater as the board is more gender diverse which implies that the representation of women on boards changes the behavior of all board members. Terjesen et al. (2009) find that gender diversity affects board dynamics but no the firm’s bottom line. By conducting a survey of 201 Norwegian frims, Nielsen and Huse (2010) argue that gender diverse boards are associated with more board strategic control and the presence of women on corporate boards seems to increase board effectiveness through reducing the level of conflict and ensuring high quality of board development activities. A considerable of work has been exploring the relationship between board gender diversity and firm value. But the results of those studies are mixed and conflicting with findings of positive, negative and no significant relationship between gender diversity and firm value.

From the individual level’s perspective, women are more risk-averse and more sensitive to ethical issues than men generally (Betz, O’Connell and Shepard 1989, Bernardi and Arnold 1997, Balkin 2000, Niessen and Ruenzi 2005). On the other hand, boards with female directorships are more effective in monitoring and advising, which is suggested by findings that women have less attendance problems and women are more independent in thinking (Adams and Ferreira 2009). Based on lots of empirical findings on the effects of women on boards, only a few researchers have tried to link board gender diversity and accounting conservatism. Boussaid et al. (2015) find that greater gender diversity encourages more conservative financial
reporting. By employing an event study approach, Zhou (2012) reveals that firms adopt more conservative accounting after transiting from an all-male board to a board with at least one female director. In contrast with the preceding findings, a study conducted by Sultana and Van der Zahn (2011) indicates that firms with female directors are associated with less accounting conservatism based on Australia data. Briefly, the evidence on the effect of board gender diversity upon accounting conservatism is inconclusive and scant.
4 HYPOTHESES DEVELOPMENT

4.1 Gender Differences

Gender differences in terms of participation in economic activity and in society are one of the most debated issues in modern times. Especially, the differences concerning ethical behaviors between women and men when money and finances are involved has been disputed and studied. There are studies suggest that men are more likely to engage in unethical behavior in the workplace. For instance, Betz, O’Connell and Shepard (1989) explore the relations between gender and the willingness to engage in unethical business behavior. They get result that women are less likely to engage in actions regarded as unethical. Bernardi and Arnold (1997) find that female managers are at a significantly higher average level of moral development than male managers through a data analysis on the survey of managers and seniors in five of Big Six accounting firms.

And the distinctly different moral orientations between women and men are supported by the “gender socialization” approach, according to Betz et al. (1989). The “gender socialization” approach suggests that men place more emphasis on money and achievement and are more likely to break rules and work long hours in order to achieve success in competitions, while women are more concerned with harmonious relationships and adhere more often to rules and laws. Similarly, Lyons (1983) finds that women focus more on relationships with others; however, men are more rights-oriented. Alternative explanation to those gender differences regarding to ethical behavior is that different sex responds to ethical issues with different degree of sensitivity. Put it simply, men are more probably to commit unethical actions than woman are because men are less sensitive to recognize situations that may involve ethical problems. Women are more likely to perceive questionable actions as less ethical than man, and are less intended to conduct those actions (Cohen et al. 1998).

Besides gender differences in terms of ethical behaviors, women and men’s different attitudes toward risks in the workplace has been discussed a lot as well. Previous research shows that women and men view risks differently when making investment
decisions. Balkin (2000) shows that women invest more risk averse than men in their 401(k) retirement plan. Agnew, Balduzzi and Sunden (2003) report a consistent result that women invest less than men in 401(k) plan. Similar results are reported by Niessen and Ruenzi (2005) who find that female mutual fund managers take less risk and have more stable investment styles than male managers. Francis et al. (2014) find that female CFOs is associated with less equity-based compensation, lower firm risk, higher tangibility level, and lower dividend payout level, which provide strong support for the notion that female CFOs are more risk averse than male CFOs. In addition, according to Barber and Odean (2001), men are more overconfident about their ability to make financial decisions than women, leading to men trade more and perform worse than women.

### 4.2 Board Gender Diversity and Accounting Conservatism

Globally, the trend that governments and businesses put more efforts to increase women’s representation is significant in recent decades. The demand for greater gender equality in the boardroom is higher than ever. And the values of gender diversity bring to business has been gradually recognized in the existing research, although some argue that the selection of female directors stems from tokenism (Adam & Ferreira 2009). Female directors tend to be more risk-aversion and less overconfident than male directors in certain areas such as finance. In addition to those traits that women can bring into the boardroom, female directors are proved to be more independent in their thinking (Adam et al. 2010), which suggests that they have different views to male directors when making decisions. Using a large panel of data on publicly-traded firms, Adams and Ferreira (2009) report that female directors have less attendance problems than male directors and the greater the fraction of female directors on the board, the fewer male directors have attendance problems. Moreover, female directors exhibit lower tolerance towards opportunistic behavior than male directors (Srinidhi et al. 2011).

Recent studies have explored the effect of board gender diversity on firm financial outcomes. And the results of those studies are mixed. Campbell and Minguez-Vera
(2008) document that the gender diversity of the board has a positive on firm value by using the panel data from Spain. Srinidhi et al (2011) find that firms with female board members perform a higher earnings quality. Carter et al. (2003) find a positive relationship between the percentage of women on the boards and Tobin’s Q of Fortune 1000 firms. By contrast, Shrader et al. (1997) fail to find any significant association between gender diversity on the boards and several accounting measures of financial performance. And consistent findings are also found from three Scandinavian countries: Norway, Denmark and Sweden. (Campbell & Minguez-Vera 2008) There are also some arguments that firm performance is negatively associated with board gender diversity. For example, Böhren and Ström (2005) report a significantly negative relationship between the proportion of women on the boards of Norwegian firm and Tobin’s Q. Adams and Ferreira (2009) find the average effect of gender diversity in the boardroom on Tobin’s Q and ROA is negative in the companies with good corporate governance. And the evidence that greater gender diverse boards may reduce firm performance could be partially explained from the point that more different opinions and more conflicts are stimulated by gender diversity. Homogeneous groups are prone to communicate frequently as they are more likely to share the same opinions, and homogeneous groups are more cooperative and experience fewer emotional conflicts. Therefore, gender diversity on the boards presumably may generate more conflicts, resulting in decision-making becomes more time-consuming and less effective (Campbell & Minguez-Vera 2008).

The board of directors is at the heart of an organization’s internal monitoring and control system. Accounting conservatism, as a potential governance mechanism can assist directors to reduce agency costs of firms as well as litigation and reputational risks since more timely recognizing losses than gains enable directors monitor managers more effectively and decrease the possibility that firms exposure to ethical problems. Female directors are more likely to adopt conservative accounting practices because they are more risk-aversion and more sensitive to ethical issues than male directors. Furthermore, Adams and Ferreira (2009) conclude that diverse boards are tougher monitors based on their findings. Boards with female members are more likely to put more auditing efforts on monitoring the production of financial accounting data, according to Gul et al. (2008). Virtanen (2012) show that female directors take more active roles and use more power than male director based on the
evidence from Finnish listed companies. And the impact of gender diversity on the effectiveness of the board is proved to be obvious based on the studies that has been discussed in the last phrases above, which implies that female directorship could enhance board monitoring. Thus, boards with female director’s presentation are more likely to employ conservative accounting practices in order to monitor management in firms more effectively. Therefore, I propose the hypothesis as follow:

H: Board gender diversity is positively associated with conditional accounting conservatism.
5 RESEARCH DESIGN

5.1 Measurements

My study seeks to the association between conservatism and board gender diversity – one of corporate governance attributes. Board gender diversity and accounting conservatism are the central objects to measure in my study. Board gender diversity as the explanatory variable, is represented by the percentage of female directors on the board. And according to Ryan (2006), conditional conservatism is more relevant to contracting issues. Thus, conditional conservatism is examined in my study. I use Basu’s (1997) measure of asymmetric timeliness of earnings as a proxy for accounting conservatism because of its simple, straight-forward interpretation. Some accounting researchers bring out concerns about the power and reliability of the differential timeliness measure developed by Basu (1997). Givoly et al. (2007) find that the Basu measure is sensitive to some characteristics such as the degree of uniformity in the content of the news during the examined period, the types of events, and the firm’s disclosure policies. The finding indicates that the control for those characteristics is required when using the Basu measure to assess the extent of conditional conservatism. Roychowdhury and Watts (2006) argues that Basu’s measure is the single-period asymmetric timeliness of earnings measure and it ignores conservatism effects prior to the estimated period, suggesting that the Basu measure is a better measure of total conservatism at a point in time when it is estimated cumulatively over multiple years preceding that time.

Though Basu’s measure is criticized due to its limitation, it still retains as the primary measure of accounting conservatism. And there are papers defending Basu’s asymmetric timeliness of earnings measure as well. Ryan (2006) endorses the Basu measure as the most direct implication of conditional conservatism. Ball et al. (2010) analyze the validity of the Basu asymmetric timeliness coefficient and conclude that estimated asymmetric timeliness coefficients reveal predicable associations with economic, legal and political institutional variables. In addition, they discuss that asymmetric timeliness estimated based on alternative research designs generate consistent results with the Basu regression coefficients, which provides additional evidence that the Basu measure can capture conditional conservatism. And I believe
that the asymmetric timeliness coefficient is a valid measure of conservatism after
the thorough literature review on accounting conservatism.

5.2 Empirical Model

Following Basu (1997), I use AT (asymmetric timeliness in earnings) to measure
conditional conservatism. In Basu (1997)’s regression model, earnings is dependent
variable and unexpected stock returns represent “economic news”. The AT measure
captures the differences in effects of negative returns and positive returns on
earnings. The original reverse-regression model is shown as follows:

\[
\frac{E_{it}}{P_{it-1}} = \alpha_0 + \alpha_1 DR_{it} + \beta_0 R_{it} + \beta_1 R_{it} \times DR_{it} + \epsilon_{it}
\] (1)

Where \(i\) and \(t\) denote each firm and each year respectively. \(E_{it}\) is net income before
extraordinary items for firm \(i\) in fiscal year \(t\). \(P_{it-1}\) is the beginning of fiscal year’s
market value of equity. \(R_{it}\) is share return in fiscal year. \(\alpha_0\) is the intercept. \(DR_{it}\) is a
dummy variable, which equals to one if stock return is negative; zero if otherwise.
The coefficient \(\beta_0\) measures the sensitivity of earnings to positive unexpected returns,
proxying for “good news”. The sensitivity of earnings to negative unexpected
returns, which proxy for “bad news” is measures by \(\beta_0 + \beta_1\). The slope coefficient \(\beta_1\)
reflects the incremental sensitivity to “bad news” as compared with “good news”,
which measures accounting conservatism. And the coefficient \(\beta_1\) is supposed to be
larger than zero because earnings respond more sensitively to “bad news” than to
“good news” under conservatism principle.

In order to test the relationship between conditional accounting conservatism and
board gender diversity, Basu’s original regression model is modified by introducing
the independent variable-board gender diversity. The variable interacts with \(DR\), \(R\)
and \(R*DR\). I control for the explanatory variable comprising firm size, leverage and
litigation risk. Each control variable also interacts with \(DR\), \(R\), and \(R*DR\). But those
similar interactions are not shown in the model for clarity purposes. The new
empirical model, as shown in Equation (2), is estimated for testing the hypotheses I have brought out.

\[
\frac{E_{it}}{P_{it-1}} = \alpha_0 + \alpha_1 DR_{it} + \beta_0 R_{it} + \beta_1 R_{it} \times DR_{it} + \beta_2 Gender\ Diversity_{it} + \beta_3 Gender\ Diversity_{it} \times DR_{it} + \beta_4 Gender\ Diversity_{it} \times R_{it} + \beta_5 Gender\ Diversity_{it} \times R_{it} \times DR_{it} + \text{Control Variables}_{it} + \epsilon_{it}
\] (2)

The effect of board gender diversity on conditional conservatism is observed on the values of coefficients $\beta_5$. And the two coefficients are expected to be positive, which suggest that board gender diversity is positively associated with accounting conservatism.

### 5.3 Control Variables

To reduce the potential effects of the omitted variable, I include firm size (SIZE), leverage (LEV) and litigation risk (LIT) as control variables in my empirical model. Firm size is measured by the natural log of average total assets. Large firms are more likely to face greater political risks than small firms, which induce large firms to use more conservative accounting practices (Watts and Zimmerman 1978). However, some researchers argue that the political risks effect on the demand for conservative accounting in large firms could be negative since large firms’ political risks could be reduced through producing more public information and mitigated due to the effect of aggregation projects. (Givoly et al. 2007, LaFond and Watts 2008) Leverage is equal to total long-term debt divided by average total assets. Leverage included as a control variable because it is an important factor that has impact on the level of accounting conservatism in firms. The second kind of agency conflicts between shareholders and debtors induce debtors demand for conservative accounting with an attempt to protect self-interests. Furthermore, shareholders also benefit from conservative accounting because the conflicts between shareholders and debtor could be mitigated via accounting conservatism and firms’ cost of debt reduces (Ahmed et al 2002). Litigation risk is represented by a dummy variable equal to 1 if the company belongs to a high-litigation risk industry, as identified by Francis et al.
(1994), and 0 otherwise. Biotechnology, computer, electronics, and retailing, the four industries are identified by Francis et al. (1994) with particular high litigation risk. The cost of litigation is higher for firms that overstate their earnings and net assets than firms that understate their earnings and net assets (Watts 2003). Therefore, more litigation risk caused by the overstatement of earnings and net assets provides managers incentives to recognize bad news more timely than good news in financial reporting.

Table 1 summarizes the definition of all the independent variables in the model.

Table 1. Independent variables definitions.

<table>
<thead>
<tr>
<th>Variables</th>
<th>Name</th>
<th>Definitions</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Explanatory Variable</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Board Gender Diversity</td>
<td>GEND</td>
<td>The percentage of female directors on the board.</td>
</tr>
<tr>
<td>Control Variables</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Firm Size</td>
<td>SIZE</td>
<td>The natural logarithm of average total assets.</td>
</tr>
<tr>
<td>Leverage</td>
<td>LEV</td>
<td>Total long-term debt divided by average total assets.</td>
</tr>
<tr>
<td>Litigation Risk</td>
<td>LIT</td>
<td>A dummy variable, equal to 1 if the company belongs to an industry with high litigation risk and 0 otherwise.</td>
</tr>
</tbody>
</table>
6 EMPIRICAL RESULTS

6.1 Data Source, Sampling and Descriptive Statistics

The sample consists of all the firms of OMX Helsinki 25 over the fiscal years 2009-2014. All the sample firms are December year-ends and their corporate governance conforms to the recommendations of Finnish Corporate Governance Code issued by the Securities Market Association. The data is mainly collected from Datastream databases. Only the data items of total board members and female board directors for firm \( i \), year \( t \) are manually collected from firm’s annual reports.

Table 2. Sample collecting procedure and sample firm breakdown by industry.

<table>
<thead>
<tr>
<th>Panel A: Sample collecting procedure</th>
<th>Firm-year observations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial sample</td>
<td>150</td>
</tr>
<tr>
<td>(-) Missing data</td>
<td>18</td>
</tr>
<tr>
<td>Final sample</td>
<td>132</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Panel B: Sample firm breakdown by industry</th>
<th>Firm-years</th>
<th>Percentage of observations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Materials</td>
<td>18</td>
<td>13,60%</td>
</tr>
<tr>
<td>Industrial</td>
<td>48</td>
<td>36,40%</td>
</tr>
<tr>
<td>Consumer Discretionary</td>
<td>6</td>
<td>4,50%</td>
</tr>
<tr>
<td>Consumer Staples</td>
<td>12</td>
<td>9,10%</td>
</tr>
<tr>
<td>Health Care</td>
<td>6</td>
<td>4,50%</td>
</tr>
<tr>
<td>Information Technology</td>
<td>12</td>
<td>9,10%</td>
</tr>
<tr>
<td>Financials</td>
<td>6</td>
<td>4,50%</td>
</tr>
<tr>
<td>Telecommunication Services</td>
<td>6</td>
<td>4,50%</td>
</tr>
<tr>
<td>Utilities</td>
<td>18</td>
<td>13,60%</td>
</tr>
</tbody>
</table>

Table 2 Panel A presents the sample collecting process. The initial sample includes 150 firm-year observations. I eliminate 18 firm-years due to missing observations in Datastream. Thus, the final sample consists of 132 firm-year observations. Table 2
Panel B presents the sample collecting process and the industry breakdown of the sample firms. And the industry breakdown follows the Global Industry Classification Standard (GICS). The industry with the largest concentration of firm-year observations is industrials, representing 36.40% of the sample.

Table 3. Descriptive statistics for key variables

<table>
<thead>
<tr>
<th>Panel A. Continuous variables</th>
</tr>
</thead>
<tbody>
<tr>
<td>Variables</td>
</tr>
<tr>
<td>-----------</td>
</tr>
<tr>
<td>E/P</td>
</tr>
<tr>
<td>R</td>
</tr>
<tr>
<td>GEND</td>
</tr>
<tr>
<td>SIZE</td>
</tr>
<tr>
<td>LEV</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Panel B. Dummy variables</th>
</tr>
</thead>
<tbody>
<tr>
<td>Variables</td>
</tr>
<tr>
<td>------------</td>
</tr>
<tr>
<td>DR</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>LIT</td>
</tr>
</tbody>
</table>

Note: E/P = net income before extraordinary items deflated by the market value of equity at the beginning of year t; R = share return in fiscal year; DR= a dummy variable, which equals to one if stock return is negative; zero if otherwise; GEND = the percentage of female board directors; SIZE = the natural logarithm of average total assets; LEV = Total long-term debt divided by average total assets; LIT= a dummy variable, equal to 1 if the company belongs to an industry with high litigation risk and 0 otherwise.

Table 3 shows the descriptive statistics for the variables included in the model that investigates the relation between conditional accounting conservatism and board gender diversity. Panel A of Table 3 indicates that the average percentage of female directors on the board is 25.6%, which is consistent with the mean value of female directors’ representation in Finnish listed companies in recent years, as reported in Spencer Stuart Board Index. The mean value of E/P ratio is 0.049. And its maximum value is 0.256 and its minimum value is -0.862. The mean value of stock return is 0.189. And the means of firm size and leverage are respectively 8.313, 0.167. Panel
B in Table 3 presents that 38.6% of the sample documents negative stock return (bad news). 22.7% of the sample belongs to industries with high litigation risk.

Table 4. The Pearson correlation

<table>
<thead>
<tr>
<th></th>
<th>E/P</th>
<th>GEND</th>
<th>SIZE</th>
<th>LEV</th>
<th>LIT</th>
<th>VIF</th>
</tr>
</thead>
<tbody>
<tr>
<td>E/P</td>
<td>1</td>
<td>-0.089</td>
<td>-0.150</td>
<td>-0.048</td>
<td>0.048</td>
<td></td>
</tr>
<tr>
<td>GEND</td>
<td>-0.089</td>
<td>1</td>
<td>0.450**</td>
<td>0.298**</td>
<td>-0.307**</td>
<td>1.407</td>
</tr>
<tr>
<td>SIZE</td>
<td>-0.150</td>
<td>0.450**</td>
<td>1</td>
<td>0.178*</td>
<td>-0.180*</td>
<td>1.260</td>
</tr>
<tr>
<td>LEV</td>
<td>-0.048</td>
<td>0.298**</td>
<td>0.178*</td>
<td>1</td>
<td>-0.195*</td>
<td>1.114</td>
</tr>
<tr>
<td>LIT</td>
<td>0.048</td>
<td>-0.307**</td>
<td>-0.180*</td>
<td>-0.195*</td>
<td>1</td>
<td>1.121</td>
</tr>
</tbody>
</table>

**Correlation is significant at the level of 0.01; *Correlation is significant at the level of 0.05.

Note: E/P = net income before extraordinary items deflated by the market value of equity at the beginning of year t; GEND = the percentage of female board directors; SIZE = the natural logarithm of average total assets; LEV = Total long-term debt divided by average total assets; LIT= a dummy variable, equal to 1 if the company belongs to an industry with high litigation risk and 0 otherwise.

Table 4 presents the Pearson correlation coefficient between the dependent variable (E/P), explanatory variable (GEND) and control variables (SIZE, LEV, LIT). Board gender diversity is not significantly correlated with E/P. And the control variables are not significantly correlated with E/P either. In addition, the control variables, firm size (SIZE), leverage (LEV) and litigation risk (LIT) are significantly correlated with the independent variable (GEND) at the level of 0.01. The Pearson correlations between one control variable and the other control variable are all significant at the level of 0.05. However, these variables can be tested together in a regression model without estimation bias since the values of variance inflation factor (VIF) are all less than 5, which indicate the absence of multicollinearity among those variables.
6.2 Results Analysis

Table 5 presents the OLS results of the effect board gender diversity on conditional conservatism. First it shows the results of the Basu (1997) regression in model 1. The slope coefficient $\beta_1$ should capture the degree of conditional conservatism and measures the incremental effects of bad news on earnings, according to Basu (1997). However, the asymmetric timeliness coefficient $\beta_1$ is 0.128 for the sample. And it is not statistically significant at the 5 per cent confidence level. This result is not in line with Basu (1997)’s prediction of earnings conservatism i.e. earnings reflect bad news at a timelier manner than good news. Meanwhile, the coefficient $\beta_0$ for good news that is predicted to be positive shows a positive number 0.001. But it is not statistically significant. The intercept term $\alpha_0$ is positive and statistically significant at 0.05 confidence level. The adjusted $R^2$ is 0.071.

Model 2 in Table 5 presents the results for the regression model in which the explanatory variable, board gender diversity and control variables (firm size, leverage and litigation risk) are included. The asymmetric timeliness coefficient $\beta_1$ is negative and is not significant in the model 2. Board gender diversity is predicted to be positively related to conditional conservatism. The effect of board gender diversity on conditional conservatism is observed on the coefficient $\beta_5$. However, contrary to the findings reported by Boussaid et al. (2015) and Zhou (2012), the coefficient of the interaction term R*DR with board gender diversity (GEND*R*DR) is 0.005 and is not statistically significant at the 5 per cent confidence level, which indicates that there is no significant effect of board gender diversity on the asymmetric timeliness. This result is inconsistent with the hypothesis of the study. And it suggests that greater gender diversity in the boardroom doesn’t necessarily lead to more prudent financial reporting practices. Moreover, the result doesn’t support the previous studies (Adams and Ferreira 2009, Gul et al. 2008) which suggest that female directorship enhances the monitoring function of the board.

The adjusted $R^2$ of model 2 is 0.285. The Control variables, firm size and litigation risk are unrelated to the asymmetric timeliness. But the coefficient interaction term
LEV*R*DR is significantly positive, which indicates that leverage is positively associated with asymmetric timeliness.

Boussaid et al. (2015) and Zhou (2012) both document that board gender diversity has a positive effect on conditional conservatism by using the samples from different countries. However, my study couldn’t be compared appropriately with the prior two studies. Firstly, my study uses Finnish firms as the source of the sample. Boussaid et al. (2015) get their findings based on evidence from French firms and Zhou (2012) studies the observations from the U.S. stock market. Secondly, my study measures conditional conservatism by following Basu (1997)’s method. Boussaid et al (2015) follow the backward cumulating approach suggested by Roychowdhry and Watts (2006) and use cumulative earnings and returns over several years instead of incorporating a single year of data into the model when estimating conditional accounting conservatism. Ahmed and Duellman (2007) explore the relation between accounting conservatism and several board of directors’ characteristics and they find that the tests with and without backward cumulating present very different results. For example, there is no significant effect of two key board characteristics, the percentage of inside directors and outsider director ownership, on the asymmetric timeliness found when estimating the asymmetric timeliness with the single year of data. Differently, they find that outside director ownership is positively associated with asymmetric timeliness and the level of insiders on the board is negatively related to asymmetric timeliness when earning and return are cumulated over several years.

<table>
<thead>
<tr>
<th>Table 5. Regression results of effects of board gender diversity on accounting conservatism</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Intercept</td>
</tr>
<tr>
<td>DR</td>
</tr>
<tr>
<td>R</td>
</tr>
<tr>
<td>R*DR</td>
</tr>
</tbody>
</table>
GEND  
\( ? \)  
\(-0.109 \)  
\((-0.513)\)

GEND*DR  
\( ? \)  
\(0.003 \)  
\((0.837)\)

GEND*R  
\( ? \)  
\(0.000 \)  
\((0.079)\)

GEND*R*DR  
\( + \)  
\(0.005 \)  
\((0.564)\)

SIZE  
\( ? \)  
\(0.015 \)  
\((0.655)\)

SIZE*DR  
\( ? \)  
\(-0.060 \)  
\((-1.357)\)

SIZE*R  
\( ? \)  
\(0.007 \)  
\((0.203)\)

SIZE*R*DR  
\( ? \)  
\(-0.044 \)  
\((-0.409)\)

LEV  
\( ? \)  
\(0.622^* \)  
\((3.057)\)

LEV*DR  
\( ? \)  
\(-0.167 \)  
\((-0.333)\)

LEV*R  
\( ? \)  
\(-0.837^* \)  
\((-2.100)\)

LEV*R*DR  
\( + \)  
\(3.978^* \)  
\((3.371)\)

LIT  
\( ? \)  
\(0.032 \)  
\((0.660)\)

LIT*DR  
\( ? \)  
\(-0.086 \)  
\((-0.751)\)

LIT*R  
\( ? \)  
\(-0.036 \)  
\((-0.497)\)

LIT*R*DR  
\( + \)  
\(-0.047 \)  
\((-0.172)\)

N  
132  
132

Adjusted R\(^2\)  
0.071  
0.285

*indicates statistical significance at the 5% level (two tailed)

Notes: The regression model: \( E_{it} / P_{it-1} = \alpha_0 + \alpha_iDR_{it} + \beta_1R_{it} + \beta_2GEND\_Diversity_{it} + \beta_3GEND\_Diversity_{it} * DR_{it} + \beta_4GEND\_Diversity_{it} * R_{it} + \beta_5GEND\_Diversity_{it} * R_{it} * DR_{it} + + \) Control Variables + \( \epsilon_{it} \). Where \( E_{it} \) is the net income before extraordinary items; \( P_{it-1} \) the market value of equity at the beginning of year \( t \); \( R_{it} \) is the annual share return for firm \( i \) in fiscal year \( t \); \( DR_{it} \) is a dummy variable, which set at 1 if \( R_{it} \) is negative and 0 otherwise; GEND = the percentage of female board directors; SIZE = the natural logarithm of average total assets; LEV = Total long-term debt divided by average total assets; LIT= a dummy variable, equal to 1 if the company belongs to an industry with high litigation risk and 0 otherwise.
The separation of ownership and control and information asymmetry induce the conflicts of interest between executives and other stakeholders to the firm. Generally, contracts are applied to mitigate those conflicts in the firm. However, due to contracts’ incompleteness, the conflicts of interest between managers and other parties cannot be solved through contracts completely. Under this situation, corporate governance mechanisms such as board of directors, institutional ownership, and managerial ownership are generated in helping reducing those conflicts.

Accounting conservatism, as one of influential accounting principles, is believed to be an efficient financial reporting mechanism in the world with incomplete contracts. Incomplete contracts are the main cause of conservatism. And conservatism has been recognized as a part of an efficient contracting mechanism (Watts 2003a). Zhou (2012) also provides empirical evidence that the degree of conservatism increases with the level of contract incompleteness. Considerable accounting studies have stressed that accounting conservatism benefits especially contracting parties such as shareholders, debt-holders, board of directors and other stakeholders to the firm. Conservatism emerges also because of other three causes, respectively, litigation, taxation and regulation, according to Watts (2003a). First, higher litigation risks lead to more conservative financial reporting. Besides, litigation costs of a firm can be lower through applying more conservative accounting practices. (Blunck 2009) Second, a firm’s tax liability in its fiscal year can be reduced through conservative reporting that lower earnings are reported. Third, accounting regulation require conservative financial reporting because regulators and standard setters are less likely to exposure to the risks of being criticized or under political pressure when firms understate their net asset value and income.

Board of directors is a key internal monitor in a firm and meanwhile, it is the core of corporate governance. On behalf of shareholders, a board of directors handles major decisions of an organization and plays an important role in monitoring management and evaluating the performance of management. However, during the monitoring and evaluating process, board of directors requires verifiable financial information with high quality in order to monitor and evaluate managers effectively (Ahmed and
Duellman 2007). And conservatism has been perceived that it constrains managers’ opportunistic behaviors and offsets managerial bias, resulting in higher accounting quality (Watts 2003a, Ahmed & Duellman 2007). Moreover, Ahmed and Duellman (2007)’s study which links accounting conservatism to different kinds of characteristics of board of directors supports that assertion that conservatism helps board of directors in reducing costs resulting from agency problems. Therefore, exploring the relation between the attributes of board of directors and accounting conservatism could be interesting. Yet so far, this academic field has not been extensively investigated. And in terms of the attributes of board of directors, prior studies have focused mainly on board independence and board size, the two attributes (Johnson et al. 2013).

Recent years, there is a growing literature that explores the composition of directors’ demography, human capital and social capital (Johnson et al. 2013). Board diversity especially gender diversity has received more and more attentions with the growing of global movement of women’s right no matter in social activities or economic activities. Female directorship has been growing steadily in the scale of worldwide. Given gender differences in regard to participation in economic activities and social activities, my thesis tends to study whether female directors are more conservative in financial reporting than male directors or not. And the purpose of my study is to examine the effect on conservatism of board gender diversity. Previous literature has documented that female are more sensitive to ethical issues and more risk-averse. Besides, there are empirical studies showing that female directors are more effective in monitoring. Thus I hypothesize that board gender diversity is positively related to accounting conservatism. There are two dimensions recognized in the literature: conditional accounting conservatism and unconditional conservatism. In my study, conditional accounting conservatism is used because it is more relevant to contracting issues (Ryan 2006).

Basu’s (1997) measure of asymmetric timeliness of earnings is used as the proxy for conditional accounting conservatism in the study. And board of gender diversity is measured by the percentage of female directors on the board. In attempt to test the relation between board gender diversity and conditional accounting conservatism, Basu (1997)’s regression model is modified by introducing the independent variable:
board gender diversity and three control variables, namely, firm size, leverage and litigation risk. And I run the modified Basu (1997)’s regression model based on the data collected from Finnish stock market. No significant effect on conditional accounting conservatism of board gender diversity is found according to the empirical analyses, which is not in line with my hypothesis that there is a positive association between board gender diversity and conditional accounting conservatism.

This study may offer some inspirations on board member selecting. However, certainly, the findings of the study should be considered cautiously due to its limitations. One of limitations of the study is the measure of accounting conservatism. Basu’s (1997) measure for conditional conservatism itself has some limitations. Thus, the possible inaccuracy of the conservatism measure may bias the reality. Secondly, many board characteristics like board independence, board size, and board activities are proven that have an effect on accounting conservatism (Ahmed & Duellman 2007, Boussaid et al. 2015). But those factors have not been controlled for the estimated model used for testing the hypothesis. Lastly, the data of the independent variable: board gender diversity is manually collected. There are possibilities that mistakes occur during the process of data collection.


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