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Accounting Conservatism and Risk Culture

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17.1 Introduction

As of April 2016, the Scopus database lists 152 products with the expression "risk culture" appearing in the title, abstract, or keywords. The concept of risk culture is broad and the topic is quite new, considering that the number of products published in the 6-year period of 2010–2015 is the same as the number published over the prior 30 years (1980–2009).

This chapter studies the relationships between accounting conservatism and bank solidity, both of which have a close relation with risk culture.

Conservatism is one of the four dimensions of accounting values that can be used to define a country's accounting culture (Gray 1988). Belkaoui (1985) defines conservatism as a preference for accounting methods that lead to a low value of equity, even when alternative choices are available.

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Solidity could be considered a dimension of risk culture according to the regulation of the Committee for European Banking Supervision (CEBS). The aim of such regulation was to overcome the weaknesses in banking management during the recent (2008) global economic crisis, highlighting the importance of a solid "institution-wide risk culture" for effective risk management (CEBS 2010). In turn, banks with a solid risk culture not only should be better capitalized but also should select high-quality capital components to absorb losses due to the risks taken.

The fragility in the measures of cultural values (Karolyi 2015), along with the fact that quantitative methods were used primarily to evaluate the risk culture indirectly (Carretta and Bianchi 2016), led us to focus on only one dimension of risk culture—that is, bank solidity.

In this research, accounting conservatism is measured by the price-to-book ratio (e.g., Stober 1996; Givoly and Hayn 2000; Zhang 2000; Ball and Shivakumar 2005; Ryan 2006; Givoly et al. 2007; Francis et al. 2015), while solidity is considered in terms of the bank's ability to absorb losses using the highest-quality component of a bank's capital—that is, according to the accounting literature (Ayadi et al. 2012), the tangible common equity as a percentage of total assets.

Analyzing a sample of 100 European listed entities that belong to the financial sector observed over the period of 2014–2015 (e.g., 200 firm-year observations), this research tests the hypothesis that a negative relationship exists between accounting conservatism and bank solidity. This is because, according to the literature (e.g., LaFond and Watts 2008; Biddle et al. 2016), there is a high demand for conservatism in entities with higher bankruptcy risk (e.g., less solid banks), compared with banks with lower bankruptcy risk (e.g., more solid banks). Because conservatism guarantees the integrity of the capital (Lacchini and Trequattrini 2002), it is expected to be higher in entities in which such integrity is threatened compared with entities whose solidity safeguards the integrity of the capital.

Results validate this hypothesis, confirming that there is a lower demand for accounting conservatism in the most solid entities. These results validate findings in the accounting literature that accounting conservatism mitigates bankruptcy risk (Biddle et al. 2016) and thus tends to decrease in the most solid entities.

Results contribute to the literature in at least two ways. First, they show how risk culture could have implications in the accounting field and, in particular, how it could affect the quality of the financial reporting process. Second, they provide first evidence showing how one dimension of risk culture (i.e., bank solidity) is negatively associated with accounting conservatism—a topic that, to the best of our knowledge, has yet to be investigated.

Findings also have implications for standard setters, suggesting that accounting quality, proxied by accounting conservatism (Barth et al. 2008; Chen et al. 2010), depends not only upon the quality of accounting standards but also upon risk management practices that, in this research, are related to the choices of the bank capital components devoted to absorbing losses.

This chapter proceeds as follows. Section 17.2 reviews the literature on the topics investigated and describes our research hypothesis. Section 17.3 details the research design. Section 17.4 presents the sample selection and the empirical findings. Finally, Sect. 17.5 concludes the paper and contains a discussion of the implications, limitations and possible future developments of the study.

17.2 Theoretical Background and Hypothesis Development

This paper studies the relationships between accounting conservatism and bank solidity in terms of the capability of financial entities to absorb losses using the highest-quality component of a bank's capital base—that is, the component with the greatest loss-absorbing capacity. We can consider solidity to be a dimension of the so-called risk culture, to the extent that we consider risk culture to be the set of practices that drive and govern risk management (Barclays PLC 2014) toward the choice of the most proper component of the banks' capital to absorb losses.

Before providing arguments that support a plausible research hypothesis about the relationships between accounting conservatism and bank solidity, we further discuss the concept of accounting conservatism,

which, according to Gray (1988), is one of the four accounting value dimensions that can be used to define a country's accounting culture.

Accounting conservatism, a dimension of accounting quality, is one of the most influential principles of accounting (Sterling 1970) and probably also the oldest of these principles. Several studies report the use of conservatism in Medieval Europe (Sterling 1970), arguing that this principle influenced the accounting practice for at least 500 years. Basu (1997) cited "Le parfait négotian" (Savary 1712) as an early textbook on conservatism. Several explanations have been given for the extensive use and persistence of conservatism in accounting, among which Watts (2003a) highlighted the role of conservatism in regulating contracts by firms and their parties, in reducing litigations, and in recognizing costs in the income statement if tax laws require it (Watts 1977; Watts and Zimmerman 1979).

Despite the wide diffusion of conservatism, there is no unique and consistent definition for this concept. Several authors have focused on the effects of conservatism in income statements, highlighting the rule to anticipate no profit but all losses (Bliss 1924) and the need to require a higher degree of verification for recognizing good news than bad news (Basu 1997). However, academics (Watts 2003a; Penman and Zhang 2002; Givoly et al. 2007) agree that the consequence of conservatism is the undervaluation of the entity's net assets relative to their economic value. Belkaoui (1985) defines it as a preference for accounting methods that lead to a lower value of equity, even when alternative choices are available.

Different authors have conflicting opinions on what conservatism means. Roychowdhury and Watts (2007) define conservatism in terms of the role of accounting, which is to report "the market value of net assets available for interim distributions to claimants, not the enterprise value of the firm" (p. 6). As a result, they consider conservatism to be the difference between the book value of net assets and the net assets' value, which includes, over the book value of net assets, the unverifiable increase in the value of separable net assets. In this framework, recognizing the difference between entity value and net asset value (i.e., rent) is not the role of accounting; consequently, the lack of recognition of rent does not represent conservatism. For Roychowdhury and Watts (2007, p. 8), an entity has rent if it has above competitive returns on current and future

investments. Therefore, rent represents growth opportunities and returns to some monopoly power.

The position of Roychowdhury and Watts (2007), which excludes the lack of recognition of rents from conservatism, is not shared by most researchers. Ryan (2006) explicitly includes in conservatism non-recognition of "unbookable" items, such as rent, and consequently states that the extent to which the market-to-book ratio exceeds one is a natural way to measure the overall degree of conservatism. Givoly et al. (2007) seem to agree with Ryan's (2006) approach. They also consider as a source of conservatism the failure of financial reporting system to capture the positive present value of projects, defining conservatism as the understatement of the firms' book value of equity relative to its economic value. Consistent with this definition, they propose the market-to-book ratio as a measure of the overall degree of conservatism. Further, Easton and Pae (2004) consider as the first form of conservatism the lack of recognition of the positive present value of a project until the associated future sales have occurred (Easton and Pae 2004, p. 496). They propose a modified version of the famous Easton and Harris (1991) model, where the coefficient of the independent variable measured by the variation of comprehensive income deflated by the beginning of the period stock prices is the measure of this part of conservatism. Finally, following Feltham and Ohlson (1995), Zhang (2000) defines conservatism as the extent to which book value differs from market value, without excluding any components of market value for the definition of conservatism.

In the accounting literature, scholars have studied the relationships between conservatism and a large variety of aspects, such as the cost of debt (Ahmed et al. 2002), the value relevance of earnings and book value (Mechelli 2013), the firm investment efficiency (Garcia Lara et al. 2016), and so on. This paper investigates the relationships between accounting conservatism and bank solidity, which is a dimension of risk culture, to the extent that cultural aspects drive and govern risk management toward the choice of the most proper component of the banks' capital to absorb losses. In this regard, the main aim of the CEBS regulation was to overcome the weaknesses in banking management during the crisis, highlighting the importance of a solid "institution-wide

risk culture" that should affect the practice of risk management to select the capital component devoted to absorb losses. In detail, banks with a solid "institution-wide risk culture" are likely to select high-quality capital components to absorb losses. For this reason, we can consider the solidity of a bank to be the result of such practices and thus to be one dimension of the risk culture of financial entities.

To formulate a plausible research hypothesis about the relation between accounting conservatism and risk culture, we inspect the positive effects of conservatism to mitigate default risks. In this regard, the literature offers contradictory findings about the association between accounting conservatism and bankruptcy risk. The most convincing of these are the findings of LaFond and Watts (2008), according to which conservatism reduces default risk indirectly by reducing information asymmetry and uncertainty, and the findings provided in the recent work of Biddle et al. (2016). Like LaFond and Watts (2008), these scholars argue that conservative accounting plays an informational role, whereby the timely reporting of bad earnings news reduces information asymmetry between debtholders and the firm, thus facilitating access to capital and debt renegotiations. This, in turn, helps the firm to avert bankruptcy filings. In addition, Biddle et al. (2016, pp. 1–2) argue that accounting conservatism decreases subsequent bankruptcy risk through its cushioning role, whereby it enhances cash availability by both reducing cash outflows and increasing cash inflows. In fact, by understating net income and assets, conservative reporting reduces the proportion distributable to contracting counterparties, thus allowing the firm to retain more cash and other assets. Conservatism also promotes precautionary cash savings and creates cushions when future earning is risky. This cushioning role of conservatism enhances firms' capacity to repay or renegotiate their debts and also increases liquidation values and debtholder rights that deter managers' strategic defaults and bankruptcy threats, thus lowering bankruptcy risk.

The literature shows also that the demand for conservatism is high in banks with higher bankruptcy risk, also thanks to the capability of conservatism to guarantee the integrity for the capital (Lacchini and Trequattrini 2002). On the contrary, in the most solid banks, whose risk culture leads managers to prefer to absorb losses using the

highest-quality component of a bank's capital, the demand for accounting conservatism should be low. Therefore, we hypothesize:

H_1 There is a negative relationship between accounting conservatism and bank solidity.

17.3 Research Methodology

To test our research hypothesis, we need variables to proxy for accounting conservatism and bank solidity. The price-to-book ratio is the measure of accounting conservatism used in this study, which, as we mentioned in the previous section, has been used by several scholars (Stober 1996; Givoly and Hayn 2000; Zhang 2000; Watts 2003b; Ball and Shivakamur 2005; Ryan 2006; Givoly et al. 2007; Francis et al. 2015) to measure both conditional and unconditional conservatism (Beaver and Ryan 2005). It is calculated by scaling the price per share with the book value per share at the reporting date. The higher the price-to-book ratio is, the higher is the level of conservatism—that is, the lack of recognition of the positive present value of a project until the associated future sales have occurred (Easton and Pae 2004, p. 496).The tangible common equity ratio as a percentage of total assets is the proxy for bank solidity. This is the highest-quality component of a bank's capital base and, therefore, is the component with the greatest loss-absorbing capacity (Ayadi et al. 2012). It is calculated by netting out intangible assets and goodwill from common equity, which comprises common stocks, retained earnings, and equity reserves. The higher the tangible common equity ratio is, the higher is the solidity of the entity analyzed.

To study the association between accounting conservatism and bank solidity, we run the following regression model:

$$\text{CONS}_{it} = \alpha_0 + \alpha_1 \text{SO}_{it} + \text{fixed effects} + \varepsilon_{it} \qquad (17.1)$$

where

CONS_{it} is the price-to-book value of entity i at the end of fiscal year t that is a proxy for accounting conservatism;

SO_{it} is the tangible common equity ratio as a percentage of total assets of entity i at the end of fiscal year t that is a proxy for bank's solidity;
fixed effects are dummies that control for omitted variables that could vary between countries and years; and
ε_{it} is the error term.

Variables included in Eq. (17.1) are bounded (i.e., positively skewed), being defined only in R+. For this reason, the linear specification does not have the best fit to our data. Following Stock and Watson (2009, p. 242), we compare the R^2 of the different specifications with logarithmic variables. The one that fits our data the best is the log–log specification. Thus, to run the regression, we calculate the natural logarithms of both the dependent variable $CONS_{it}$ and the independent variable SO_{it}. Equation (17.1) also includes countries and years' fixed effects. Country fixed effects are useful to avoid biasing the research results due to omitted variables that vary over time but remain unchanged between countries; temporal effects, on the other hand, control for omitted time-invariant variables that change between countries.

Our expectation is to find the regression coefficient α_1 negative and statistically significant at the traditional level (e.g., 5%), validating the hypothesis that there is a negative relationship between accounting conservatism and bank solidity.

17.4 Sample Selection and Empirical Findings

To study the relationship between accounting conservatism and bank solidity, we focus on a sample of financial entities listed in the active markets of countries belonging to the EU at the time of issuance of EU Regulation 1606/2002 that, over the period 2014–2015, comply with the rules of the Basel III accord. The use of this time frame allows us to analyze entities that have complied with the same Basel capital requirements.

Table 17.1 Geographical portrait of the entities analyzed

Countries	Entities	Countries	Entities
Austria	5	Italy	20
Belgium	3	Ireland	2
Denmark	17	Netherland	4
Finland	2	Portugal	3
France	14	Spain	8
Germany	6	Sweden	4
Greece	4	UK	8
		Total	100

The table reports the 14 EU countries analyzed and the number of entities (e.g., 100) included in the sample to test our research hypothesis. Because we analyzed two fiscal years (2014 and 2015), it is possible to calculate the number of firm-year observations available in this study (200)

Data has been collected from the Bankscope database. Moving from an initial sample of 234 entities, the final sample (after exclusions for missing data) includes 100 entities (200 firm-year observations).

Table 17.1 describes the geographical portrait of the entities analyzed.

As we can see, the majority of entities are listed in Italy, Denmark, and France. Countries with a lower number of financial entities are smaller or have missing data. Actually, downloading data from the Bankscope database led us to drop several observations, because in some cases, data were not available. For this reason, Luxembourg does not appear in the table.

Table 17.2 tabulates the percentiles, the mean, and the standard deviation of the variables used to test our research hypothesis.

In the sample analyzed, the price-to-book ratio of the entities is a bounded variable that assumes only positive observations. It ranges from values close to zero to values higher than two. Its median value is +0.69, and its mean is +0.85. Entities with price-to-book ratios under the median are those with a low level of conservatism, while entities with a price-to-book ratio over the median are those with a high level of conservatism. Also, the tangible common equity as a percentage of total assets is a bounded variable that assumes in the sample analyzed, only positive values, except for two firm-year observations that have negative values for this variable. For this reason, in our regression model, the number of firm-year observations is 198 and not 200. The percentiles of

Table 17.2 Descriptive statistics

	Percentiles					Mean	Std. dev.	$CONS_{it}$	SO_{it}
	5	25	50	75	95				
$CONS_{it}$	+0.05	+0.47	+0.69	+1.01	+2.01	+0.85	+0.77	+1	
SO_{it}	+2.63	+4.72	+6.62	+10.60	+14.91	+7.63	+3.75	−0.05	+1

The table reports the percentiles, the mean, the standard deviation, and the Pearson correlation coefficient of the price-to-book ratio ($CONS_{it}$) and the tangible common equity as a percentage of total assets (SO_{it}), which proxy, respectively, for accounting conservatism and bank solidity

SO_{it} show that, in the sample, the less solid entities are those with a tangible common equity double compared with total assets and the most solid entities are those with a tangible common equity that is about 15 times higher than total assets.

The correlation coefficient tabulated in Table 17.2 provides interesting insight about the validation of our research hypothesis. In fact, the Pearson correlation coefficient shows that the variables $CONS_{it}$ and SO_{it} are negatively correlated (e.g., −0.05), suggesting that when solidity increases, the level of conservatism should decrease. Also the Spearman's rho (not tabulated) is negative (e.g., −0.13), allowing us to reach robust conclusions about the correlation between the two variables.

In Table 17.3, we tabulate results of our regression model, which are useful to test the association between $CONS_{it}$ and SO_{it}.

Our findings seem to validate our research hypothesis that accounting conservatism is negatively associated with bank solidity. As expected, the regression coefficient of SO_{it} is negative (e.g., −0.306) and statistically significant at 1%. The interpretation of this result is strictly correlated with the specification that we use to test our hypothesis. In a log–log model (Stock and Watson 2009, p. 242), this means that an increase of +1% of the tangible common equity is associated with a reduction of 30.6% of accounting conservatism.

Findings validate the argument that the more the bank is solid in terms of capability to absorb losses with high-quality capital components, the lower is the demand for accounting conservatism. This is consistent with the literature that provides evidence that the demand for conservatism mitigates bankruptcy risk in entities whose risk culture leads risk management to select low-quality capital components to absorb losses.

Table 17.3 Research results

	Coefficient	Standard error	*T*-statistic	*P* > |*t*|
_constant	+0.007	+0.403	+0.020	+0.985
SO_{it}	−0.306	+0.113	−2.700	+0.008
Fixed effects	(omitted)			
No. of obs: 198			*R*-squared: +0.55	
F-statistic: 14.62			Adj *R*-squared: +0.51	
Prob > *F*: 0.00			Root MSE: +0.71	

The table reports the results of our multivariate analysis, regressing the price-to-book ratio ($CONS_{it}$) with the tangible common equity as a percentage of total assets (SO_{it}), and in particular the regression coefficients, their standard errors, *t*-statistics, and *p*-values. The table also shows the number of observations, the *F*-statistic and its *p*-value, measures of goodness-of-fit (e.g., *R*-squared and adjusted *R*-squared), and the root mean square error

To test the robustness of our findings, we re-run our regression model within the continental countries, where attitudes toward conservative accounting are higher. According to Gray (1988, p. 10), conservatism varies according to country, ranging from a strongly conservative approach in the Continental European countries, such as France and Germany, to the much less conservative attitudes of accountants in the UK. Excluding the UK and Ireland, our findings continue to be validated, with the regression coefficient of SO_{it} equal to -0.43 and statistically significant at 1% (e.g., *p*-value < 1%). Also, excluding UK, Ireland, Denmark, and The Netherlands, and thus running the regression over the so-called weak equity countries of Nobes (2008), our findings continue to be validated. In this case, the regression coefficient is −0.54, statistically significant at 1% (e.g., *p*-value < 1%).

17.5 Discussion and Conclusion

Risk culture is a broad concept that scholars have only begun in recent years to investigate with both theoretical and empirical analyses. Among other aspects, risk culture influences the risk manager's activities regarding the choice of the bank's capital components that have to absorb losses, affecting the solidity of the financial entity. This chapter investigated the relationships between accounting conservatism and bank

solidity (a dimension of risk culture), opening the interest of accounting studies toward the risk culture concept and the dimensions that scholars could use to proxy it.

Results show not only the presence of a negative correlation between accounting conservatism and bank solidity but also the presence of an association of the same sign. This finding demonstrates that banks with a solid risk culture, with the attitude to select high-quality capital components to absorb losses, are those with a lower demand for conservatism. This is consistent with the literature that shows how, in entities with high bankruptcy risk (e.g., less solid banks), the demand for accounting conservatism is higher compared with banks with low bankruptcy risk (e.g., more solid banks).

Despite the contribution and the implication of this research, it is limited in that we focus on only one dimension of risk culture—that is, the attitude of the risk manager within the firm to select the most proper bank capital to absorb losses due to the manifestation of risks. Focusing only on one dimension of risk culture is unavoidable for quantitative studies for two reasons: first, because there is fragility in the measures of cultural values (Karolyi 2015), and second, because quantitative methods are used primarily to evaluate the risk culture indirectly (Carretta and Bianchi 2016). Future research could focus on other dimensions of risk culture. They could also use a different proxy to control for bank solidity in order to validate the hypothesis of this research. For instance, another proxy of bank solidity is the attitude toward financing total assets using equity instead of debt. So, future research could verify whether conservatism is negatively associated with the European bank's attitude toward financing total assets by using equity instead of debt. Banks that are less leveraged (e.g., more solid) should experiment lower levels of conservatism, assuming that conservatism is useful to mitigate bankruptcy risk. Future research could also study whether firms' characteristics, such as the business model used, affect the relation between conservatism and bank solidity. The motivation of such interest regarding the business model is due to the awareness that within different business models, we can find different risk cultures. Actually, there is a strict relation between the business model concept and risk in financial entities (Mechelli et al. 2017). According to the recent regulation,

the risk-taking process, the governance arrangements, the prices of assets and liabilities offered to clients, the firm performance, and the adequacy of the leverage ratio should be coherent with the business model of financial entities. As of January 1, 2018, the accounting policies for measuring financial instruments will also be influenced by the business model of such entities, leading us to hypothesize that different business models identify different risk cultures.

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