

## AN INVESTIGATION OF BONDHOLDER-SHAREHOLDER CONFLICT IN ACCOUNTING CONSERVATISM

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### ABSTRACT

*This study investigates bondholder-shareholder conflict in the banking industry in Indonesia. The banking industry has a high complexity, a large information risk, contractual differences, and strict regulations, that result in the high possibility of applying conservative accounting (Hsu, Novoselov, & Wang, 2017). This study uses panel data and multiple regression. Samples were taken from the banking financial statements in Indonesia from the Jakarta Stock Exchange in the 2016-2018 period by using purposive sampling under criteria of including the availability of complete financial statements, and from the banking sector industry. By using 66 observations, we found that first, bondholder conflict was related to accounting conservatism through two proxies, STDROA and LEV. Second, through the Basu coefficient we found that the banking industry in Indonesia adopted accounting conservatism. Third, bond-holder conflicts and accounting conservatism in the banking industry can only be proven through dividend and leverage policies.*

*Keywords:* conservatism, bondholder-shareholder conflict, the banking industry

### INTRODUCTION

In this paper we investigate the bondholders-shareholder conflicts and accounting conservatism in Indonesia. Accounting conservatism research is still an interesting research theme. This is quite reasonable, since according to Basu (1997), conservatism has influenced accounting practices for more than 500 years. Also Thijssen & Iatridis (2016) state that the practice of accounting conservatism has increased over the past seven years. Ball (2001) argues that accounting conservatism is one of the fundamental characteristics of financial reporting. Accounting conservatism is also still being debated among academics and standard setters (Khalifa et al., 2019). A standard setter, FASB, in this case does not accommodate conservatism as a qualitative attribute of financial statements. This is because accounting conservatism causes bias in financial statements and overrides neutrality (Ruch & Taylor, 2015). Meanwhile, some academics believe that accounting conservatism can reduce managers' opportunistic behavior (Brown et al., 2006). Watts (1993) suggests that conservatism likely evolved from the contracting role of accounting. He also argue that existency of accounting conservatism helps avoid inappropriate distribution to claim holders.

It is imperative to investigate the association between bondholder conflict and accounting conservatism because a debt contract is one of the most important external contracts for the company and can influence investment decisions, compensation, and even financial reporting (Aghamolla & Li, 2018). On the other hand, bondholders, as external parties, must also obtain collateral, so that the risk of default risk does not occur. This is what drives the bondholders to ask the borrowing company to apply conservative accounting (Chen et al., 2010). Watts (2003) mentions that the bondholder is a very interested party and requires accounting conservatism (Nikolaev, 2010).

The previous study has shown that accounting conservatism successfully mitigates bondholder-shareholder and accounting conservatism conflicts (Ahmed et al., 2012). Two bondholder conflict proxies—the standard deviation of ROA and dividend policy—are positively correlated with accounting conservatism. Only one proxy is still mixed, i.e. leverage. In Indonesia, a study conducted by Sari (2004) found that bondholder-shareholder conflict is related to accounting conservatism. Although many prior studies examine the relation between accounting choice and debt covenant. The more general role of conservatism in debt contracting, especially in banking industry, has not received much attention. We extend the test by involving the proxy of capital intensity in investigating bondholder conflicts with accounting conservatism. On the other hand, based on the researcher's knowledge, this study is the first study to investigate bondholder conflict and accounting conservatism in the banking industry in Indonesia.

We measure bondholder-shareholder conflict through four approaches. first, operating uncertainty, dividend policy, leverage, and capital intensity. Operating uncertainty is a standard deviation of return on assets, dividend policy is a comparison between cash dividends and total assets. Leverage is the ratio between long-term debt and total assets, and capital intensity is the ratio between total assets and total sales. We also use two measurements of accounting conservatism. The first approach we use is the approach (Givoly & Hayn, 2000) and the second (Basu, 1997).

In sum, the results of this study indicate that the conflict between bondholders and shareholders is related to accounting conservatism. Some proxies including STDROA and LEV have been proven to be related to accounting conservatism. We also find evidence that banks in Indonesia still adopt the practice of accounting conservatism, but are not comprehensive. Bondholder conflict and accounting conservatism in the banking industry can only be proven through dividend and leverage policies. Our study is expected to contribute in several ways. First, we provide empirical evidence of accounting conservatism in the banking industry. Second, the study adds to the development of literature related to accounting conservatism in the banking industry. Third, we hope this research can be useful for regulators and accounting standard-setter, especially banking regulators in formulating their policies and standard-setter in determining the cut-off between the principle of neutrality and accounting conservatism. This research is also relevant for other studies with similar themes.

This study was organized as follows. First is the literature review and formulation of hypotheses, second is the research method used, third is the result of research and discussion, and fourth is conclusion.

## LITERATURE REVIEW & HYPOTHESES DEVELOPMENT

### *Relationship between Bondholder Conflict and Accounting Conservatism*

Bondholder-shareholder conflict with accounting conservatism can be traced through positive accounting theory. Referring to positive accounting theory (Watts & Zimmerman, 1986), accounting conservatism in the form of accounting method selection is inseparable from bonus plan, political, and debt covenant hypotheses. Following Watts (2003), accounting conservatism will limit managers to include bias and noise in financial statements. In other words, accounting conservatism limits opportunistic payment behavior to managers in the form of bonuses and also to shareholders in the form of dividends. Thus, the use of conservative accounting will reduce the possibility of paying dividends that are too high for shareholders. Kalay (1982) found that companies use two forms of restrictions in debt contracts. First, it directly limits the number of dividends paid from profit. Second is indirectly through financial ratios. For example is through the ratio of debt to assets. Dividend payments will reduce assets. Thus, the debt ratio will limit the payment of dividends to shareholders. In line with that, according to Ahmed et al. (2000), debt contracts carried out by bondholders incorporate accounting conservatism into two things. First, the contract explicitly states that it requires the use of conservative accounting. Second, managers explicitly commit to using conservative accounting consistently. This commitment is needed by the bondholder to guarantee its interests. Thus, companies that have the potential to experience bondholder-shareholder conflict will apply conservative accounting. This assumption is in line with a study research conducted by Ahmed et al. (2000), in which the higher the bondholder-shareholder conflict, the higher the application of conservative accounting. The increasing application of accounting conservatism is consistent with the study of Shuto & Takada (2010). The results of their study found that the application of accounting would be able to reduce agency problems and conflicts between managers and shareholders.

Based on this description, we formulate our following hypotheses:

H<sub>1a</sub>= The banking industry with high bond-shareholder conflicts tends to adopt accounting conservatism.

H<sub>1b</sub> = Bondholder conflict has a positive effect on accounting conservatism

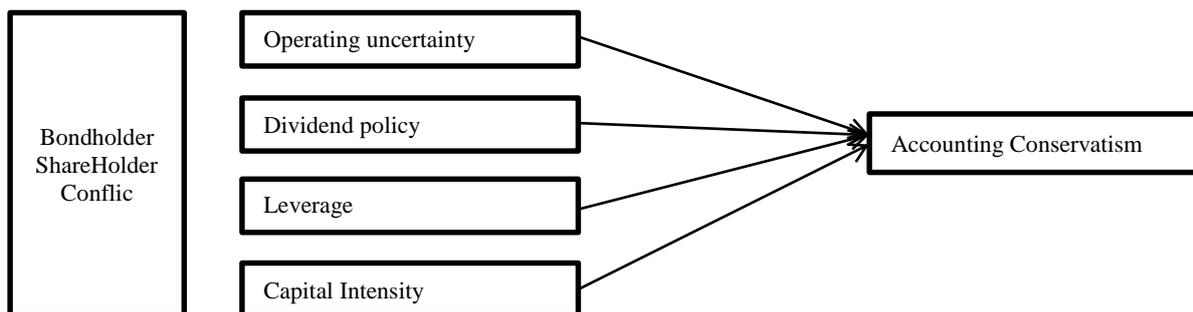
## RESEARCH METHOD

### *Sample*

This research uses panel data and multiple regression. Samples were taken from the banking financial statements in Indonesia through the Jakarta Stock Exchange in the 2016-2018 period by using purposive sampling under criteria of including the availability of complete financial statements, and from the banking sector industry. We used the banking industry as a sample because banking is a regulated industry compared to other industries (Almutairi & Quttainah, 2019). The banking industry is also more prominent in accounting conservatism because of its high complexity, large information risks, contractual differences, and strict regulations. (Hsu et al., 2017). Based on the sample selection, we obtained 23 banks listed on the exchange with 66 observations.

### *Research Model*

This study follows Ahmed et al.'s (2012) model. Conservatism becomes the dependent variable and bondholder and shareholder conflicts become the Independent variable. The model is further discussed below.



Picture 1: Research Model

### *Measuring Bondholder-Shareholder Conflict*

Following Ahmed et al. (2012), bondholder conflicts can be proxies by operating uncertainty, dividend policy, leverage, and capital intensity. According to Watts (1993), when managers have their difficulty in estimating future profitability, they will tend to use conservative accounting. The greater the difficulty in estimating it, the greater the possibility of dividends to be paid to shareholders. Therefore, for the bondholders, in anticipation of dividend overpayment, they will require the use of conservative accounting. Dividend policy is a policy that is implemented by companies in dividend payments. The higher the ratio of dividend payments to assets owned by the company, it will encourage bondholders to require the use of conservative accounting (Ahmed et al., 2000).

Leverage indicates the composition of debt to assets. The higher the debt, the greater the Bondholder's claim on assets. In the end, it will increase conflicts between Bondholders and Shareholders. As such, Bondholders will require the use of conservative accounting (Ahmed et al., 2000). Capital intensity indicates the use of capital in generating income. Capital-intensive companies will have greater political costs, and they will tend to choose conservative accounting (Almilia, 2005). Table 1 represents the measurement of bondholder-shareholder conflict.

**Table 1: Measuring bondholder-shareholder conflict**

Subvariable	Variable measurement
operating uncertainty	the standard deviation of ROA
dividend policy	common dividends divided by total assets
Leverage	long-term debt divided by total assets
Capital Intensity	Total assets divided by total sales

**Measuring Accounting Conservatism**

Following Balakrishnan et al. (2016), to measure accounting conservatism can be done through three models. The first model is the C-Score. C-Score is a model developed by Khan & Watts (2009). The second model is Skewness. This model was developed by Givoly & Hayn (2000). The third model was developed Basu (1997). This study uses two models that represent conditional and nonconditional conservatism. First is the model developed by Basu (1997) and second is the model developed by Givoly & Hayn (2000), involving accruals, which is the difference between net income before depreciation and amortization with cash flow.

We use Basu's (1997) model because this model is a valid model for measuring conservatism (Nguyen et al., 2018; Roychowdhury, 2006). The model developed by Basu (1997) is as follows:

$$x_{it} = \beta_1 i + \beta_2 D_{it} + \beta_3 R_{it} + \beta_4 D_{it} * R_{it} + \epsilon_{it} \dots\dots\dots(1)$$

where  $X_{it}$  is Earning,  $R_{it}$  is stock return,  $D_{it}$  is an indicator variable, equal to one if stock return negative, and  $\epsilon$  is an error term

To see the indications of conservatism, we follow Francis et al. (2013) in using Bas coefficient. Basu coefficient is a comparison between sensitivity to recognize bad news to sensitivity to recognize good news. The second model is a model developed by Givoly & Hayn (2000). According to this model, an indication of accounting conservatism can be seen through the tendency of accruals over several years which are negative. This means that net income is smaller than operating cash flow. The model developed by Givoly & Hayn (2000) is as follows:

$$CONNACC_{it} = NI_{it} - CFO_{it} \dots\dots\dots(2)$$

where CONNACC is the level of conservatism, NI is net income less depreciation and CFO is Cash Flow Operating.

**Measuring Control Variable**

Following Ahmed et al. (2012), we use the control variable size, sales growth, and return on assets. Size is the natural logarithm of total assets. Sales growth indicates the percentage change in sales, to control growth, and return on assets is a comparison between net income and total assets, to control profitability.

**Hypothesis Testing**

To test hypothesis 1, we use the following Basu's (1997) measurements:

$$x_{it} = \beta_1 i + \beta_2 D_{it} + \beta_3 R_{it} + \beta_4 D_{it} * R_{it} + \epsilon_{it} \dots\dots\dots(3)$$

$$Coefficient_{Basu} = \frac{Sensitivity\ to\ Bad\ News}{Sensitivity\ to\ Good\ News} = \frac{(\beta_{3i} + \beta_{4i})}{\beta_{3i}} \dots\dots\dots(4)$$

The higher the Basu coefficient, the more conservative the accounting is applied. (Francis et al., 2013). To test hypothesis 2, and to investigate the bondholder-shareholder conflict with accounting conservatism, and referring to Ahmed et al. (2012), we estimate the regression equation:

$$CONSERV = \alpha + \beta_1 BONDHOLDER + CONTROL + \epsilon \dots\dots\dots(5)$$

Where CONSERV is accounting conservatism that refers to the model developed by Givoly & Hayn (2000). BONDHOLDER involves four measurement proxies, i.e., operating uncertainty, dividend policy, leverage, and capital intensity. As a control variable, we involve variables related to bondholder conflicts. Referring to Ahmed et al. (2012), we used the control variables of size, sales growth, and return on assets. Size is the natural logarithm of total assets. Sales growth indicates the percentage of

change in knowledge in sales to control growth, and return on assets is a comparison between net income and total assets to control profitability.

## RESULT & DISCUSSION

### Descriptive and Correlation Analysis

Table 2 reports summary statistics for the 2016-2018 period. Panel A illustrates the average, maximum and minimum values, and standard deviations of each variable with a proxy for accounting conservatism using the approach from Givoly & Hayn (2000).

**Table 2: Summary Statistic**

Variable	Mean	Min	Max	Std.Dev				
<b>PANEL A : Measuring of accounting conservatism using the model (Givoly &amp; Hayn, 2000)</b>								
CONNACC	-920,919	-35,944,586	25,811,630	9,257,208				
STDROA	0.0052	0.0002	0.0573	0.025973				
DIV	0.0052	0	0.01006	0.0075				
LEV	0.0188	0.0001	0.0636	0.0163				
CAPIT	153.17	10.030	3,605.19	566.29				
SIZE	7.3268	5.8226	0.1129	0.9111				
SALESGRO	287,889	-11,691,138	15,932,186	2,971,014,22				
ROA	0.0008	-0.1173	0.03134	0.02682				
<b>PANEL B: Correlation Analyses</b>								
	CONNACC	STDROA	DIV	LEV	CAPIT	SIZE	SALESGRO	ROA
CONNACC		0.09	-0.47	0.07	-0.29	-0.16	-0.18	-0.033
STDROA	0.09		-0.31	-0.09	-0.12	-0.23	0.26	-0.59
DIV	-0.47	-0.31		0.17	0.55	0.60	0.08	0.39
LEV	0.07	0.091	0.17		0.04	0.45	0.16	0.002
CAPIT	-0.29	-0.12	0.55	0.03		0.37	-0.013	0.17
SIZE	-0.16	-0.23	0.60	0.45	0.37		0.11	0.42
SALESGRO	-0.18	0.26	0.088	0.16	-0.013	0.11		0.043
ROA	-0.033	-0.59	0.39	0.002	0.17	0.42	0.043	
CONNACC : an accrual-based measure of conservatism, the mean ratio of total accrual before depreciation, to total assets								
STDROA : the standard deviation of ROA (a proxy for operating uncertainty)								
DIV : common dividend divided by total assets (a proxy for dividend policy)								
LEV : long-term debt divided by total assets								
CAPIT : total assets divided total sales								
SIZE : the log of total assets								
SALESGRO : the annual percentage change in sales (a control for growth opportunities)								
ROA : the net income before extraordinary items, divided by total assets (a control for profitability)								

Based on table 2 above, the level of conservatism in the banking industry is an average of 2,363,601, a maximum value of 25,811,630 and a minimum value of -7,148,010 and a standard deviation of 6,648,788.43. Based on these, we find that banks industry in Indonesia practice accounting conservatism, which is as predicted by Hsu et al. (2017). The average STDROA and DIV were 0.0052, the average LEV 0.01, the average CAPIT 153, the average SIZE 7.3, the average SALESGRO 287, and the average ROA 0.0008. Panel B represents the correlation between CONAACC, STDROA, DIV, LEV, CAPIT, SIZE, SALESGRO, ROA variables. Based on the table, it is consistent with our prediction that STDROA and LEV are positively correlated, but very weak, only in the range of 7 to 9 percent. Contradicting our expectations, the other bond-holder variables, i.e., DIV, and CAPIT, are not positively correlated.

### Conservatism and Bondholder-Shareholder Conflict

Table 3 reports how the banking industry adopts accounting conservatism and how bondholder-shareholder conflict relate to accounting conservatism. First, we tested the Basu coefficient, Second, we selected the model. From the balance panel data, we chose a random effect model. Third, we analyzed how each variable is statistical.

**Table 3: Summary statistic from the regression of Accounting Conservatism on proxies for Bondholder-shareholder conflict and Coefficient<sub>Basu</sub>**

Variable	Predicted Sign	Coefficient	t-statistic	Prob*	Prob**	Prob***
Intercept		-5084490	-0.445454	1.3152	0.6576	0.1352
proxies for Bondholder-shareholder conflict						
STDROA	+	56548934	0.646796	1.0404	0.5202	0.1040
DIV	+	-2.04E+09	-3.471130	0.0002	0.0010	0.0002
LEV	+	95265220	1.274216	0.4148	0.2074	0.0415
CAPIT	+	-715.025	-0.321168	1.4984	0.7492	0.1498
Control variable						
Size	+	678949	0.403027	1.3766	0.6883	0.1377
Sales Growth	-	-0.7723	-1.681173	0.1956	0.0978	0.0196
ROA	+	80709339	1.524216	0.2652	0.1326	0.0265
Adjusted R <sup>2</sup>	0.24					
Sample Size	66					
Coefficient <sub>Basu</sub>	1					

\* sig 0.1

\*\* sig 0.05

\*\*\* sig 0.001

Based on the Table above, After controlling through the control variable, consistent with H<sub>1a</sub>, STDORA as an uncertainty operating proxy and LEV are related to accounting conservatism. This is under our predictions. Consistent with H<sub>1a</sub>, we also found a high Basu coefficient, so it can be concluded that the banking industry in Indonesia adopted accounting conservatism. Our statistical results provide evidence that the DIV is significant at levels 5 and 1 percent with the direction of the negative coefficient. However, LEV is significant at the level of 1 percent. Meanwhile, the DIV and CAPIT coefficients are negative and these results are inconsistent with our expectations. Therefore, bond-holder conflicts and accounting conservatism in the banking industry can only be proven through dividend and leverage policies. Overall, the results of our study do not support the study of Ahmed et al. (2012). However, the significant control variables that can affect bondholder and shareholder conflicts are SALES GRO and ROA at the level of 1 percent.

## CONCLUSION

Our study investigates bondholder-shareholder conflict in the banking industry concerning accounting conservatism practices. We suspected that bondholder-shareholder conflict will increase managers' preferences to choose higher conservative accounting. Our study is a replication of a study conducted by Ahmed et al. (2012). We focus on the banking industry because this industry is an industry that stands out in accounting conservatism due to its high complexity, large risk of information, contractual differences, and strict regulations (Hsu et al., 2017).

The research found that first, bondholder conflict was related to accounting conservatism through two proxies, STDROA and LEV. Consistent with our prediction, STDROA and LEV are positively correlated, but very weak, only in the range of 7 to 9 percent. These results simultaneously answer the second research hypothesis and support the study of Ahmed et al. (2012). Second, through Basu coefficient, on average we find that banks industry in Indonesia practice accounting conservatism. These results simultaneously answer the second research hypothesis and support the study of Ahmed et al. (2012). Third, bond-holder conflicts and accounting conservatism in the banking industry can only be proven through dividend and leverage policies. This study supports the study of Hsu et al. (2017), Ahmed et al. (2000), and Shuto & Takada (2010). We provide evidence that bondholder-shareholder conflict is related to accounting conservatism. For other developing countries such as Indonesia, assets and leverage need attention. This is because both of them are based on research results related to the level of conservatism. Control over assets and leverage can be done through a debt contract mechanism. These developing countries can contract debt, so they can accommodate the interests of bondholders and shareholders.

Our study has limitations. First, our sample only involves banks listed on the stock exchange with a period of only three years. Future studies are expected to use larger sample and longer period of time. Second, we only involved two proxies in measuring accounting conservatism. Future studies can analyze in terms of changes in accounting conservatism itself. Third, we are using minimal inconsistency and sensitivity tests. Further studies can carry out additional tests to support the results of our performed regression.

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