Accounting conservatism and corporate governance: evidence from the Indian banking sector

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Abstract: This study examines the relationship between accounting conservatism and corporate governance in the Indian banking sector. Trust in banking system of a country requires presence of efficient corporate governance mechanism. Conservative accounting practices supplement corporate governance effectiveness as they are supposed to curtail opportunistic behaviour of managers, counters agency problems and promotes efficient contracting mechanisms. This study hypothesised that better governed banks shall be more conservative than the others. For the purpose of this study, Basu (1997) model is used for measuring conservatism and Sarkar et al. (2012) rankings as corporate governance measure. The results of this study confirm that better governed banks follow more conservative accounting practices.

Keywords: accounting conservatism; corporate governance; asymmetry; banking; India.

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1 Introduction

Conservatism has influenced accounting practice and theory for centuries (Basu, 1997). Sterling (1970) claims that the notion of conservatism is, "the fundamental principle of valuation in accounting." It is an important accounting principle and is used for assessing the quality of financial reporting (Xu and Lu, 2008). Traditionally, accounting conservatism is defined by the adage "anticipate no profit, but anticipate all losses" (Bliss, 1924). In view of the uncertainty attached to future events, profits are not anticipated and are recognised only when it is realised; provision is made for all known liabilities and losses even though the amount cannot be determined with certainty (AS 1, ICAI). Conservatism is accountants' tendency to require a higher degree of verification for recognising good news than the bad news in financial statements (Basu, 1997). As a result of differential verification there is persistent understatement of net asset values which further results in average market value being higher than the book value (Watts, 2003). Managers often possess private valuable knowledge about the company's operations and assets value and if their compensation is linked to earnings they may withhold information which adversely affects their compensation. The evolution of conservatism principle can be attributed to managerial attempts to exploit their asymmetrical informed position relative to their claimholders (Basu, 1997). It produces accounting numbers that reduces these moral hazard problems in contract among parties (García Lara et al., 2007).

The financial statements to be of high quality must be understandable, reliable, relevant and comparable and it should provide full and fair disclosure. The reported financial information is expected to influence the actions of users of that information (Bhatia, 2017), through accounting conservatism financial reporting enhances its reliability as it provides for timely reporting of expected loss. As per Kirk and Siegel (1996) "prudent reporting based on healthy skepticism builds confidence in the results and in the long run best serves all of the divergent interests that are represented by the [FASB's] constituents." As per the study conducted by Graham et al. (2002) analyst accord more importance to accounting conservatism than to reported earnings and revenue recognition policy. Conservatism is classified into two broad forms that is, unconditional conservatism and conditional conservatism (Ball and Shivkumar, 2005). Unconditional conservatism is not event specific and thus has relatively consistent impact on financial statements and it is carried out through reporting low book values of net assets relative to their market value. As per study by Qiang (2007), the purpose is to avoid taxes, litigation risk and accounting regulations. Conditional conservatism is ex post in nature, it is news dependent conservatism which occurs when negative economic news is recognised in accounting earnings in timelier manner than the positive economic news (Ruch and Taylor, 2015). This results in asymmetric recognition of the positive and negative news; it is defined as asymmetric timelines (Basu, 1997) or asymmetric verification (Watts, 2003) conditional on an event.

Going by the research in the area of conservatism, conditional conservatism is more prevalent than unconditional conservatism; it may be because it communicates information regarding unexpected events. As per research the conditions for these types of conservatism are also different, conditional conservatism happens in settings where contracting and litigation costs are high and unconditional conservatism happens where litigation, regulatory and tax costs are high (Qiang, 2007). Research also suggests that application of one type of conservatism affects the application of other type of conservatism. Beaver and Ryan (2005) observed that unconditional conservatism creates accounting slack and that prevent the application of conditional conservatism.

Watts (2003) provides four potential explanations for the existence of conservatism in accounting, i.e., contracting explanation, shareholder litigation, taxation and regulation; and as per Watts (2003) the contracting explanation is most exhaustive and is an early source of conservatism and the arguments are fully developed. As per governance theory through symmetric timeliness of earnings, shareholders monitor managers more effectively. More than a few studies advocate that the Corporate governance mechanisms can augment the level of accounting conservatism (Ahmed and Duellman, 2007; Qiang, 2007; Elshandidy and Hassanein, 2014; Kukah et al., 2016) as per these studies firms with higher quality governance mechanism impose accounting conservatism on managers. Few other studies suggested that corporate governance mechanisms can bring down the level of accounting conservatism (Chi et al., 2009; Lim, 2011)

Banking sector is a true representative of knowledge-based industry (Bhatia and Mehrotra, 2016); is the main participant of the financial system in any country (Khanna and Kaushal, 2013) and it plays a pivotal role in the development of economy and forms the core of the money market (Ahluwalia, 2002). Banks undertake credit intermediation; operate on higher leverage, deals in people's savings, central in the transmission of monetary policy and is absolute necessity for a well-functioning economy. Good governance is essential for all kinds of entities but it has deeper significance in case of banks and financial institutions. Better corporate governance mechanism would offset the weakened incentive for monitoring through robust internal controls. Public trust is at the core of banking system, through better governance structures the confidence and trust can be enhanced which is essential for banking sector and the economy as a whole (Leventis et al., 2013). The complexity of the banking business increases the asymmetry of information and reduces stakeholders' capacity to monitor bank managers' decisions (Andres and Vallelado, 2008). Literature suggests that corporate governance may significantly influence the quality of accounting information; many studies examine the relation between corporate governance and financial reporting quality (Dechow et al., 1996). Study by García Lara et al. (2007) proposed that there should be direct association between the effective governance structure and conservatism and the results of their study indicated that governance results in conservatism as it helps in fulfilling the monitoring role.

Watergate scandal in the USA in 1970s gave birth to the concept of corporate governance. Subsequent developments in the USA triggered debate in the UK in this direction. In 1980s and 1990s, several investors (including banks) suffered huge losses due to numerous scandals and disastrous episodes in corporate world in the UK. Cadbury report of the UK published in 1992 was the first step in contemporary corporate governance. It codified the desirable governance mechanisms to strike the balance between powers of board of directors and their accountability. In India, the first initiative in this direction was taken by Confederation of Indian Industries (CII) in December 1995 by coming up with the desirable code of corporate governance. Later in 2000, Securities and Exchange Board of India (SEBI) came up with mandatory code of corporate governance for listed companies. Institutionalisation of corporate governance in banks got initiated with setting up of advisory group under the chairmanship of Dr. R.H. Patil. Reserve Bank of India (RBI), subsequently, took various measures to strengthen, corporate governance in Indian banks. The policy framework of RBI for various governance aspects is more or less uniform for private and public sector banks of India.

The RBI supervises the corporate governance practices of Indian banks under the guidance of Board for Financial Supervision. One of the key method used by RBI in this regard is off-site surveillance mechanism which comprises of monitoring managerial practices in banks relating to capital adequacy, income recognition and asset classification. RBI issues prudential norms in this regard, which the bank managers are expected to implement. RBI advises bankers to be conservative when it comes to income recognition and asset classification to ensure preparedness to meet unforeseen circumstances and to build strength in Indian banking sector. Effective governance structures are essential for proper functioning of banking sector. Despite the robustness of corporate governance related regulations and supervision methods Indian banking industry has witnessed several governance issues time and again. Recent troubles with Axis Bank, ICICI Bank and Punjab National Bank indicate the need for strong governance practices. S&P Global Ratings also cautioned Indian banks in this regard recently. Under-reporting of non-performing loans has also been a serious issue in Indian banking sector. RBI's intent has always been to ensure conservatism in accounting practices of banks for achieving higher threshold for corporate governance practices in Indian banks. Accounting conservatism restricts managerial manoeuvring tendencies and helps in reducing agency problems. Our study explores whether better governed banks are more conservative in their accounting practices.

Our line of research is based on contracting governance theory which deals with ways in which suppliers of finance to corporations assure themselves of getting return on their investment (Shleifer and Vishny, 1997). The present study investigates whether listed banks in India which have an effective corporate governance structure demands conservative financial reporting. To our knowledge, we are the first to explore the relationship between corporate governance and conservative accounting in Indian banking sector setting. The presence of conditional conservatism in Indian firms has been established in an earlier study (Vishnani and Misra, 2016). The research examined the association of corporate governance with accounting conservatism for 12 years period. For measuring accounting conservatism reverse regression model coined by Basu (1997) has been used and for examining the association modified Basu (1997) model has been used. To identify better governed banks corporate governance ranking given by Sarkar et al. (2012) has been used.

2 Literature review

Various studies have been conducted to investigate the relation between:

1 board characteristics and firms performance (Abdullah, 2004; Bauer et al., 2004; Haniffa and Hudaib, 2006; Ponnu, 2008; Brown and Caylor, 2009; Abidin et al., 2009)

2 board characteristics and voluntary disclosures (Haniffa and Cooke, 2002; Ahmed et al., 2006; Baek et al., 2009; Akhtaruddin et al., 2009; Akhtaruddin and Haron, 2010)

3 board characteristics and earnings management (Klein, 2002; Xie et al., 2003; Bedard et al., 2004; Saleh et al., 2005; Chen et al., 2007).

The existing literature on the association between corporate governance and accounting conservatism is limited despite many studies based in developed world highlighting the advantages of conservatism in the agency relationship. Firms incur high agency costs as agents (managers) are driven by self interest (Jensen and Meckling, 1976), thus firms use varied ways to bring down the agency costs and they will select the bouquet of governance processes that enhances the value of the firm (Ahmed and Duellman, 2007). The governance debate emphasises that managers must act in the interests of external stakeholders (Fama, 1980). Well functioning corporate governance mechanism is considered as an effective way in reducing agency costs (Mohamed Yunos, 2011) and it reduces managers' opportunistic behaviour (Watts, 2003). Through conservative accounting, information asymmetry and uncertainty can be lessened and it is anticipated that weak governance formation will cause higher demand for conservative accounting (Chi et al., 2009, LaFond and Watts, 2008). Extant literature suggest that conservatism in accounting is result of effective corporate governance mechanism (Beekes et al., 2004; LaFond and Roychowdhury, 2006; Lin, 2006; Ahmed and Duellman, 2007).

Beekes et al. (2004) examined the association between quality of accounting and governance which extended the prior research done by Basu (1997). Their study was based on UK-listed non-financial firms from 1993–1995. Findings of the study indicated that the firms with higher percentage of non-executive directors display higher conservatism in accounting through timeliness in reporting bad news in earnings and similar findings were reported by Ahmed and Duellman (2007) which investigated relation between accounting conservatism and board of directors' characteristics; this study was based on US firms and the time period covered by the study is 1999–2001. It used three surrogates for conservatism, namely market value proxy (CON-MKT) followed by Beaver and Ryan (2005), accrual-based proxy used by Givoly and Hayn (2000) and third one based on Basu's (1997) asymmetric timeliness of earnings measure. The study by Chi et al. (2009) was conducted on Taiwan listed non-financial companies from year 1996–2004 has taken a contradictory view, which is the substitutive role of conservatism for other corporate governance mechanisms; the results indicated that an organisation with a comparatively weaker governance mechanism demands conservatism in accounting.

García Lara et al. (2007) conducted a study to find whether stronger corporate governance will exhibit a higher degree of accounting conservatism, they found that the Spanish firms with stronger governance structure use conservatism more than the weaker ones and this is due to better execution of conservatism through recognition of bad news. Recent findings by García Lara et al. (2015) suggest that there is improvement in investment efficiency (firms facing liquidity constraints) as a result of conditional conservatism. As per study by Ball (2001), conservatism helps the board in spotting projects with negative NPV by timely detection of economic losses else mangers have tendency to delay or avoid reporting losses. It suggests that conservatism facilitates directors in monitoring key decisions.

Donglin and Song (2009) carried out a study in Chinese setting to explore the determinants of conservative accounting using 2001–2006 data. Their findings were that, debt followed by ownership is the most important determinant of conservatism in China and board has little influence and the level of accounting conservatism is consequence of compliance to accounting standards. As per Zhang (2008) conservatism lowers the cost of debt.

The study by Suleiman (2014) was on food and beverages firms of Nigeria and the objective of the study was to investigate the effect of corporate governance mechanisms on conservative accounting. The results revealed that higher the proportion of independent directors more will be the accounting conservatism and the firms with larger board size are less conservative.

In the empirical study based in Egypt (Nasr and Ntim, 2018) it was concluded that the board independence is positively associated with accounting conservatism. It was also concluded that the board size and auditor type are negatively associated with accounting conservatism. The study based in Ghana (Kukah et al., 2016) explored the implications of CG mechanism for information quality by using discretionary accrual as proxy; the findings indicate that the board independence and foreign ownership constraint opportunistic managers to manipulate the earnings leading to a higher level of accounting information quality.

Study conducted by Leventis et al. (2013), was based on US banks with effective corporate governance structure. It was observed that banks with stronger CG structure were reporting bad news in timely manner and thus were practicing higher level of conservatism in accounting.

There's been extensive research across continents in this area in last three decades but most of this research has been conducted in developed countries; the corporate governance standards in different countries vary owing to the separate cultural values, social and political circumstances (Mohammed et al., 2017). It is necessary to study the association in Indian context as this is an unexplored area and as per the recent study based in India (Vishnani, 2017) the corporate governance mechanism does have effect on quality of financial reporting. The Indian banking industry has been through a long journey and witnessed a number of changes (Bhatia and Mulenga, in press) and there have been changes in the financial reporting and the CG mechanism too. To the best of our knowledge no study based in India explored the association between corporate governance mechanisms and accounting conservatism for banking sector.

2.1 Objectives of the study

On the basis of motivation drawn from the literature review, the primary objective of our study is to examine whether better governed banks in India are relatively more conservative in their accounting practices. Our study is motivated by the fact that existing literature in the related area is majorly comprised of studies in the context of developed economies like the USA, the UK, etc. while very few studies exist for emerging markets and none for India. Further, most of the existing studies reviewed above are concentrating more on board characteristics as a measure of corporate governance. Some also consider audit structures and anti-takeover provisions for the estimation of corporate governance measure. However, the corporate governance index used in our study captures four important dimensions of corporate governance viz., board of directors, ownership structure, audit committee and auditor. Banking industry, being the regulated industry, is strictly monitored by its regulator, RBI with regard to selection and appointment of statutory auditors for the bank.

In line with the purpose of this study, following hypothesis is constructed; the first two are based on Basu's (1997) original model and the third one is based on modified Basu's model.

Hypothesis 1 Current recognition of unrealised gains from previous periods is not correlated with current news.

This hypothesis shall be tested by the intercept terms of equation (1). If α_0 and α_1 come out to be positive and statistically significant, this hypothesis gets proved.

Hypothesis 2 Earnings are more sensitive to negative stock market returns than to positive stock market returns.

This hypothesis shall be tested by the coefficient terms of equation (1). If β_1 comes out to be positive and statistically significant, this hypothesis gets proved.

Hypothesis 3 The level of conservatism for strongly governed banks is higher than weakly governed banks.

This hypothesis shall be tested by coefficient terms for 'bad news' companies in equation (2). If β_3 is negative and β_1 is positive and both are statistically significant, this hypothesis gets proved.

3 Research design

3.1 Sample selection and research model

The present study has explored the association between corporate governance and conservative accounting for Indian banking sector with the help of Basu (1997) model for measuring conservatism and Sarkar et al. (2012) for measuring corporate governance.

The data has been extracted from the PROWESS database of Centre for Monitoring Indian Economy. There are 50 listed banks in India of which 33 banks have been considered for study due to data pruning. The period of study ranges from financial year 2003–2004 to 2014–2015. To get the balanced panel, we had to eliminate certain data observations and finally we were left with 354 firm-year observations. These 33 banks constituted approximately 93% of the total market capitalisation of all listed Indian banks. The data was extracted on 26th December 2015.

To test Hypothesis 1 and Hypothesis 2, Basu (1997) model is used. This model has been widely used for capturing conditional accounting conservatism. As per Basu (1997) publicly available 'bad news' is more quickly incorporated in earnings as compared to 'good news' if a firm is conservative in its accounting practices, leading to asymmetric timelines. Basu (1997) has used reverse regression to prove that accounting earnings incorporate 'bad news' faster than 'good news'. Common stock returns (R_{it}) were taken as proxy for good and bad news as stock prices incorporate all the information arriving in the market from various sources very promptly. The interactive slope coefficient, β_1, measures the differential sensitivity of accounting earnings to negative and positive stock market returns. It is expected to be positive and statistically significant to show the asymmetrical timeliness in incorporating bad news vis-à-vis good news.

To assess the magnitude of conservative accounting in banking sector, we used the Basu (1997) model. Basu (1997) has been extensively used to measure conditional conservatism in extant studies (Bushman and Pitroski, 2006; Givoly and Hyan, 2000; Roychowdhary and Watts, 2006; Ball, 2001 and many others). Basu's (1997) seminal study links financial reporting to economic profits/losses. Income/loss recognition in accounting often involves a discretion on the part of managers to incorporate it today or defer it to future period(s). Conservatism requires more timely recognition of bad news than good news. Ball et al. (2013) has established adequately in their study that Basu's (1997) asymmetric timeliness measure is a valid measure of conditional conservatism when exploring conditional conservatism in the context of contracting. Also, their study proves that Basu's (1997) measure is a reliable measure if we control for firm specific control variables. Since our study is in the context of single sector (i.e., banking sector) and also context of contracting prevails, Basu (1997) is considered to be an appropriate model for capturing conditional conservatism.

Basu's model is specified below:

$$E_{it} = \alpha_0 + \alpha_1 D_{it} + \beta_0 R_{it} + \beta_1 R_{it} D_{it} + u_{it} \tag{1}$$

where

i indexes the firm

t indexes year

E_{it} equals annual earnings per share in year t scaled by beginning stock price

R_{it} is the firm's common stock return from nine months before fiscal year-end t to three months after fiscal year-end t

D_{it} equals one if R_{it} is negative ('bad news') or zero when returns are positive ('good news')

u_{it} is the disturbance term.

To test Hypothesis 3, we use modified Basu (1997) model. Modified Basu (1997) model incorporates the corporate governance rank as an interactive variable to capture the impact of corporate governance practices on level of accounting conservatism in firm. Agency conflicts amongst various stakeholders of the firm have been the main reason for corporate governance regulations in corporate (Berle and Means, 1932; Jensen and Meckling, 1976). Corporate governance mechanisms are meant to address agency problems by effectively monitoring management and contracts entered into by various stakeholders of the firm. Better governance structures demand conservatism in accounting practices so as to get the benefits of such monitoring and controls. Conservatism in accounting practices discourages the managers' tendency to defer the recognition of losses, thus minimising the agency costs (Ball and Shivkumar, 2005). Thus the role of accounting conservatism in minimising the agency costs emanates the need for conservative accounting practices for effective firm monitoring. Hence, we hypothesise that firms with better corporate governance practices shall follow higher degree of conditional conservatism as compared to firms with weaker corporate governance structures.

Corporate governance ranking used in our study has been borrowed from Sarkar et al. (2012). Sarkar et al. (2012) developed a corporate governance index for top 500 Indian listed companies based on the data pertaining to board of directors, ownership structure, audit committee and external auditor of these companies. This corporate governance ranking was compiled using extensive set of characteristics based on literature and related regulations. Also the corporate governance index was validated in the paper of Sarkar et al. (2012). This data was captured for the period ranging from 2003 to 2008. The 500 companies under study were divided by them into five groups based on the worth of their corporate governance index. The companies with highest index value were categorised in group 1 and the companies with lowest index value were categories in group 5.

Modified Basu's model, used in our study, is specified below:

$$E_{it} = \alpha_0 + \alpha_1 D_{it} + \beta_0 R_{it} + \beta_1 R_{it} D_{it} + \beta_2 R_{it} CG_{it} + \beta_3 CG_{it}.D_{it}.R_{it} + u_{it} \tag{2}$$

where

i	refers the firm
t	refers year
E_{it}	equals annual earnings per share in year t scaled by beginning stock price
R_{it}	is the firm's common stock return from nine months before financial year-end t to three months after financial year-end t
CG_{it}	is the corporate governance ranking developed by Sarkar et al. (2012). Rank 1 depicting the best governed companies and rank 5 depicted worst governed companies
D_{it}	equals one if R_{it} is negative and zero otherwise
u_{it}	is the disturbance term.

It is expected that strongly governed firms will show relatively higher sensitivity of accounting earnings towards bad news as existence of sound corporate governance practices in a firm will demand conservatism in accounting practices and prompts recognition of 'bad news'. Hence, the interactive slope coefficient, β_1, is expected to be positive and, β_3, is expected to be negative as the strongly governed firms' conservatism coefficient is expected to be higher than weakly governed firms' conservatism coefficient.

3.2 The empirical results

Table 1 presents the summary statistics of the variables used in model 1 and model 2 specified above. The banks in our sample reported mean accounting earnings of 14.6% vis-à-vis mean stock market return of 14.3%. Median earnings are less than mean earnings indicating positively skewed earnings. The same phenomenon is existent in stock market returns as well. The mean corporate governance ranking of the banks is 3.172 on the scale of 1 to 5, 1 indicating the best and 5 indicating the worst. 39.5% of the firm-years are negative stock return firm-years as indicated by the mean of dummy variable.

Table 1 Descriptive statistics

	E	*R*	*D*	*D * R*	*CG*	*CG * D*	*CG * D * R*	*CG * R*
Mean	0.146	0.143	0.395	–0.116	3.172	1.288	–0.370	0.441
Standard error	0.006	0.025	0.026	0.011	0.053	0.091	0.035	0.081
Median	0.128	0.126	0.000	0.000	3.000	0.000	0.000	0.255
Standard deviation	0.119	0.463	0.490	0.199	1.002	1.709	0.654	1.517
Sample variance	0.014	0.215	0.240	0.040	1.004	2.920	0.428	2.301
Kurtosis	9.651	0.522	–1.826	4.478	–0.658	–1.207	7.959	1.182
Skewness	2.259	0.431	0.429	–2.092	–0.538	0.744	–2.445	0.550
Range	1.138	2.706	1.000	0.935	4.000	5.000	4.551	10.521
Minimum	–0.224	–0.935	0.000	–0.935	1.000	0.000	–4.551	–4.551
Maximum	0.914	1.771	1.000	0.000	5.000	5.000	0.000	5.969
Sum	51.684	50.756	140.000	–41.022	1,123.000	456.000	–130.998	156.010
Count	354.000	354.000	354.000	354.000	354.000	354.000	354.000	354.000

Table 2 depicts the estimations of model 1. The results reflect presence of conditional conservatism in banking industry. Adjusted R^2 is at acceptable level of 12%. The results indicate strong direct relationship between earnings and stock market returns as the coefficient for Return is positive and highly statistically significant. The coefficient for return * dummy is significantly positive indicating higher sensitivity of accounting earnings towards negative stock market returns (proxy for bad news). It can be observed that the intercept term is positive and significant. Thus, the incorporation of negative news in accounting earnings is of a higher level vis-à-vis incorporation of positive news. The results adequately prove our Hypothesis 1 and Hypothesis 2. Similar findings were reported in Basu (1997), García Lara et al. (2005) and Pae (2007). Although, Molenaar (2009) reported in his study on US banking industry negative coefficient for return * dummy indicating that US banks were not conservative during 2000 to 2007.

Table 2 Basu's reverse regression results

	Coefficients	*t-stat*
Intercept	0.13	10.60
D	0.03	1.49
R	0.09	3.90
R * D	0.08	1.57
Adjusted R square	0.12	

Note: $E_{it} = \alpha_0 + \alpha_1 D_{it} + \beta_0 R_{it} + \beta_1 R_{it} D_{it} + u_{it}$.

Table 3 depicts estimates of model 2 wherein we estimate the impact of corporate governance practices on level of accounting conservatism in Indian banking industry. Our results show positive coefficient value for return * dummy which is highly statistically significant while negative coefficient value corporate governance rank * return * dummy which is also highly statistically significant. This indicates that level of conservatism for strongly governed banks is higher than weakly governed banks. The total conservatism (β_1 + β_3) of poorly governed firms is smaller than that of effectively governed firms because higher corporate governance rank indicates poor governed firms and vice-versa. Our findings are in agreement with García Lara et al. (2009) and Leventis et al. (2013). Positive intercept is an indication of accounting conservatism, as conservatism affects earnings downwardly, the intercept is expected to have a positive sign.

Table 3 Modified Basu's (1997) reverse regression results

	Coefficients	*t-stat*
Intercept	0.13	10.72
D	0.03	1.53
R	–0.10	–2.25
R * D	0.36	3.69
R * CG	0.06	4.68
CG * D * R	–0.09	–3.27
Adjusted R square	0.17	

Note: $E_{it} = \alpha_0 + \alpha_1 D_{it} + \beta_0 R_{it} + \beta_1 R_{it} D_{it} + \beta_2 R_{it} CG_{it} + \beta_3 CG_{it}.D_{it}.R_{it} + u_{it}$.

Overall, it is evident from the results that:

- Indian banks are conditionally conservative in their accounting practices. They recognise bad news in their accrual earnings more promptly than good news
- banks whose governance structures are weaker, are less conditionally conservative in their accounting practices as compared to banks whose governance structures are stronger
- banks with strong governance structures use conservative accounting practices for effective monitoring and control.

4 Conclusions

This study examined the association between corporate governance and accounting conservatism in the Indian banking sector. It uses two models, one to measure accounting conservatism (Basu, 1997) and another to study the link between corporate governance and accounting conservatism (Basu, 1997). It was hypothesised that better governed banks shall be more conservative than the others. For measuring corporate governance, ranking provided by Sarkar et al. (2012) has been used.

Results through model 1 revealed, presence of accounting conservatism in Indian banking sector as there is higher sensitivity of accounting earnings towards negative stock market returns. This confirms presence of asymmetric timelines as Indian banking sector respond more quickly to bad news than to good news. This is the first study which measures accounting conservatism in Indian banking sector. Results through model 2 indicate that the better governed banks with higher corporate governance ranking are recognising the bad news more timely vis-à-vis the banks with corporate governance lower ranking.

The result of the present study indicate that there is presence of accounting conservatism in Indian banking sector and the better governed banks are more conservative than the weak governed banks. Results are in consistent with García Lara et al. (2009) and Leventis et al. (2013) and are inconsistent with Chi et al. (2009), as per their findings weaker governance structures tend to be more conservative as the proclamation they have gone by is that the weaker governance structures tend to demand more conservative accounting as conservatism is a substitute for corporate governance mechanisms. Substitutive role of conservatism does not hold true in India, specifically in Indian banking sector.

Our study contributes to existing literature in this domain in three ways. First, ours is the first kind of study in Indian context done so far which relates the effectiveness of corporate governance mechanisms to conservatism in accounting practices. Second, conservatism in accounting is a desirable practice for Indian banks as per the thrust of regulator (RBI). Our study is an effort in this direction to establish the implementation of such accounting policies and practices. Third, role of effective corporate governance in implementing the conservative accounting policies is highlighted by our study. This may draw the attention of regulators to take the necessary steps to enhance the effectiveness of corporate governance mechanism in Indian banks. A recent incident happening in one of the leading public sector banks of India (Punjab National Bank) is an apt example of poor governance structure. Though most of the public sector banks are listed, not all regulations of SEBI, the capital market regulator, are applicable for them. For instance, the requirement to have one-third of directors to be independent is not mandatory for listed public sector banks of India.

4.1 Managerial implications

The findings of our study have implications for bank managers as well as regulators. Indian banking sector, under the supervision of RBI, is currently preparing for transiting to Indian Accounting Standards (Ind AS). These standards require major overhaul in existing financial reporting practices of banks. Ind AS 109, financial instruments, requires more stringent provisioning norms using expected credit loss (ECL) method as compared to existing prudential norms provisioning. This means that banks are required to be more conservative in their accounting practices. Managers are motivated to be more conservative to avoid litigious situations. Our study brings forth the importance of strong governance structures in ensuring higher level of accounting conservatism. Thus, the regulators (RBI, BFS and SEBI) need to ensure better corporate governance mechanisms for banks. Recent happenings of Indian banking sector (Punjab National Bank, ICICI Bank and Axis Bank) also point out the weaknesses of governance structures of banks. Even the listed banks in India are not complying with corporate governance requirements. Many listed banks get exemptions from related regulations if they are state owned. Thus a corporate culture is required to prevail for all the banks, irrespective of private or public. Regulators need to give due thrust to bringing in place strong corporate governance mechanisms. This is expected to result into higher level of accounting conservatism being followed by bankers.

Future research on the accounting conservatism and corporate governance can compare the banking sector with other sectors in India and/or other countries. Also, one can test the association of individual components of corporate governance with accounting conservatism. This may bring forth the critical domains of corporate governance deserving more attention of regulators.

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