Abstract: This paper examines the relationship between equity-based compensation to outside directors and accounting conservatism. Equity-based compensation to outside directors can strengthen the firm’s corporate governance structure. Since this strong governance reduces the information asymmetry between managers and shareholders, it is also possible that firms with strong governance use more conservative accounting. To test this prediction, we investigate whether the proportion of the equity-based compensation to total compensation to outside directors has an effect on the level of conservatism and the various measures that are used. We find that there is a positive relationship between the proportion of equity-based compensation and the level of conservatism. The results are robust to additional tests using alternative measures of the equity-based compensation (the amount of the equity-based compensation) and the equity-based compensation to audit committee members instead of the full board of directors. According to our findings, we can conclude that equity-based compensation to outside directors encourages directors to put more effort into reducing the information asymmetry using conservative accounting.

Key Words: Equity-based compensation · Accounting conservatism · Information asymmetry · Corporate governance
Equity-Based Compensation to Outside Directors and Accounting Conservatism

1. Introduction

This paper investigates the relationship between equity-based compensation to outside directors and accounting conservatism. Recently, research focused on equity-based compensation to outside directors has sharply increased (e.g., Ryan and Wiggins, 2004). Recent evidence shows that equity-based compensation to outside directors makes them more align with the shareholders, so it strengthens corporate governance in the firm (e.g., Yermack, 2004; Fich and Shivdasani, 2005). And it is already clarified that strong corporate governance can effectively mitigate the information asymmetry between managers and shareholders by improving financial reporting transparency and encouraging voluntary disclosures of better quality information (e.g., Ajinkya et al., 2005; Karamanou and Vafeas, 2005). Meanwhile, conservative accounting is another way to reduce the information asymmetry. Accounting conservatism helps reduce agency costs arising from asymmetric information, such as payoff functions and limited liability (e.g., Watts, 2003; Watts, 2006). Therefore, firms with higher corporate governance have incentives to conservatively recognize their earnings in order to reduce information asymmetry.

However, there is no research about the effect of equity-based compensation to outside directors on accounting conservatism. As we mentioned above, accounting conservatism is one way to reduce agency costs or information asymmetry, and the board of directors also tries to reduce this information asymmetry. Equity-based compensation to outside directors provides incentives for mitigating the information asymmetry between managers and shareholders due to the alignment of the interests of outside directors and shareholders. So, it is possible to think that outside directors